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Review
A JOURNAL OF ECONOMIC POLICY
THIRD QUARTER 2002

Will they make it?

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THE MILKEN INSTITUTE REVIEW • THIRD QUARTER 2002

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Michael L. Klowden, *President and CEO*
Michael Milken, *Chairman*

PUBLISHER
Joel Kurtzman

EDITOR IN CHIEF
Peter Passell

ART DIRECTOR
Joannah Ralston, Insight Design

MANAGING EDITOR
Larry Yu

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Requests for additional copies should be sent directly to:

The Milken Institute
The Milken Institute Review
1250 Fourth Street, Second Floor
Santa Monica, CA 90401-1353
310-998-2600 telephone
310-998-2627 fax
info@milkeninstitute.org
www.milkeninstitute.org

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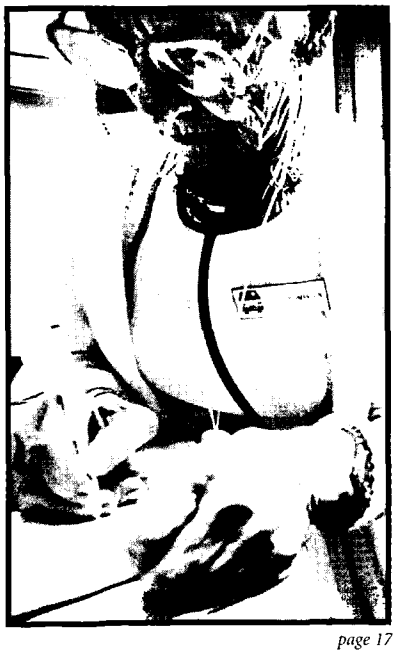

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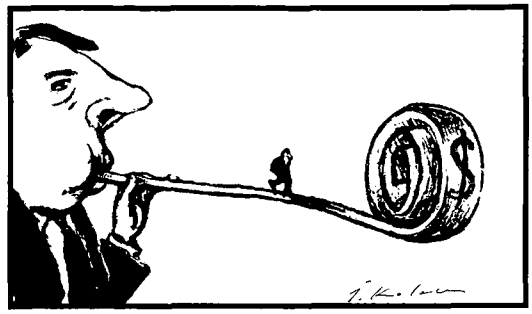

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FROM THE PRESIDENT

The past few months have been very active for the Institute. This spring, we released our 2002 Capital Access Index, issued the latest Forbes/Milken Institute Best Places ranking, and held our annual Global Conference, at which some 1,500 leaders of business, finance, education and government participated in 29 different sessions featuring over 150 panelists. The discussions covered a wide range of topics central to our theme, "Building Prosperity in an Interdependent World." You may listen to these panel discussions on our Web site – www.milkeninstitute.org.

This issue of the *Review* offers a sampling of not only these highlights, but other important issues that we focus on.

Topping things off is a roundtable discussion among Nobel laureates in economics at the Global Conference. This year's panelists included Gary Becker and Robert Fogel of the University of Chicago, Myron Scholes of Stanford University, and Robert Mundell of Columbia University. Becker pioneered work in human capital; Scholes revolutionized finance; Fogel integrated modern economics into the study of history; Mundell created the matrix by which currency unions are judged.

As excerpts from the proceedings make very clear, none of the nobelists is afraid to stray from paths previously trodden. Indeed, under the able guidance of moderator Mike Milken, the gang mixes it up on subjects ranging from the euro to China to access to medical care (see page 76).

A central theme in the Institute's research is the importance of "democratization" of capital in solving social and economic problems. And the transparency of financial markets is a key to the democratization process, both at home and abroad. Starting on page 87, the Institute's capital markets group presents its latest Capital Access Index, along with an analysis by Institute researchers James Barth, Don McCarthy, Triphon Phumiwasana, Susanne Trimbath and Glenn Yago.

While perusing the issue, don't forget to look at Institute demographer Bill Frey's charticle. Bill specializes in analyzing trends in the U.S. population; his contribution is keyed to the latest releases from the 2000 Census.

All of this great work, of course, depends on support from people like you. To that end, I'm delighted to announce the appointment of James W. Osterholt as vice president for development. Jim was formerly the executive director of development for the RAND Corporation. And before that, he was responsible for immensely successful private funding efforts for UCLA.

His goal and ours, of course, is to sustain a mix of research and public outreach in a variety of topics. With your support, we'll be able to continue our good work – including the many great articles you'll find in the *Review*.

Drop me a line (mklowden@milkenistitute.org) and let me know what you think.

Mike Klowden

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You may have the leisure this summer to sample the new vintage in Montalcino or to social climb in Aspen. But here at the Milken Institute sweatshop we've been working 24/7 to pack the *Review* with brilliant articles. Well, make that 8/5, with frequent breaks for frappuccinos.

Robert Litan, director of economic studies at the Brookings Institution, examines proposed post-Enron fixes of financial accounting standards and finds them lacking. "A central problem with any monopoly standard-setter is that it has no incentive to respond quickly to market forces, let alone to resist political influence," he writes. "As in private markets, the solution to monopoly is competition."

David Levine, formerly chief economist at Sanford Bernstein, sees efforts to add a private component to Social Security as a diversion from the core issue of how to pay for the retirement of the big, baby boom generation.

"By delaying retirement commensurate with gains in longevity," he argues, "benefits could be maintained without raising taxes because the ratio of workers to retirees would remain high enough to cover the bill." Readers craving more on this subject may wish to listen to the proceedings of a 2002 Global Conference panel, "Pensions: Financing Retirement Across Longer Lifespans," found with a couple of clicks on the Institute's Web site (www.milkeninstitute.org).

Gavin Buckley, a specialist in international finance at the U.S. Treasury, takes a close look at the agency in charge of cleaning up Japan's monumental banking mess. "While the Resolution and Collection Corporation has often been likened to America's Resolution Trust Corporation, which was instrumental in resolving the savings and loan crisis in the United States," he writes, "neither the RCC's bureaucracy nor the government defines its mandate in a way that offers much hope of a fix anytime soon."

For other views, check out the audio recording of this year's Global Conference panel, "Can Japan Compete in the 21st Century" on the Institute's Web site.

Now for dessert – not one, but two book excerpts. **George Soros**'s modestly titled *On Globalization* is anything but modest in conception. The billionaire currency-speculator-turned-philanthropist outlines a plan for dramatically increasing both the quality and efficacy of foreign economic aid.

In *Globalization and Its Discontents,* Nobel Prize-winner **Joseph Stiglitz**, does not mince words about his least-favorite international organization. Thanks to the IMF's handling of the Asian financial crisis, he writes, "capital markets will work less efficiently and the growth of living standards will be slowed. Indeed, the IMF policies in East Asia had exactly the consequences that have brought globalization under attack." – *Peter Passell*

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BY WILLIAM H. FREY

According to census figures released in June, one-quarter of Americans now have college degrees – an all-time high. During the 1990s, the number of people with a sheepskin increased by well over a third, while high-school dropouts declined. But the bounty of the educated is not evenly distributed across the country.

States and local communities wishing to improve their tax bases, and cash in on the knowledge economy, have done their best to lure the best and the brightest. At the same time, new immigrants with below-average education are locating in gateway regions where affluence has driven demand for low-skill services – restaurant workers, office

LARGE METROS WITH HIGHEST "BRAINS TO BRAWN" RATIOS

Metro areas over one million population with highest ratios of college graduates to high school dropouts*

1. Minneapolis-St. Paul, MN-WI (3.53)
2. Seattle-Tacoma-Bremerton, WA (3.04)
3. Raleigh-Durham-Chapel Hill, NC (2.66)
4. Denver-Boulder-Greeley, CO (2.66)
5. Washington-Baltimore, DC-MD-VA-WV (2.46)
6. Austin-San Marcos, TX (2.41)
7. San Francisco-Oakland-San Jose, CA (2.32)

LARGE METROS WITH LOWEST "BRAINS TO BRAWN" RATIOS

Metro areas over one million population with lowest ratios of college graduates to high school dropouts*

1. Las Vegas, NV-AZ (0.79)
2. Miami-Fort Lauderdale, FL (0.88)
3. Los Angeles-Riverside-Orange County, CA (0.90)
4. San Antonio, TX (0.99)
5. New Orleans, LA (1.01)
6. Greensboro-Winston-Salem-High Point, NC (1.07)
7. Houston-Galveston-Brazoria, TX (1.12)

*Persons age 25 and above who graduated from college, divided by persons aged 25 and above who did not complete high school

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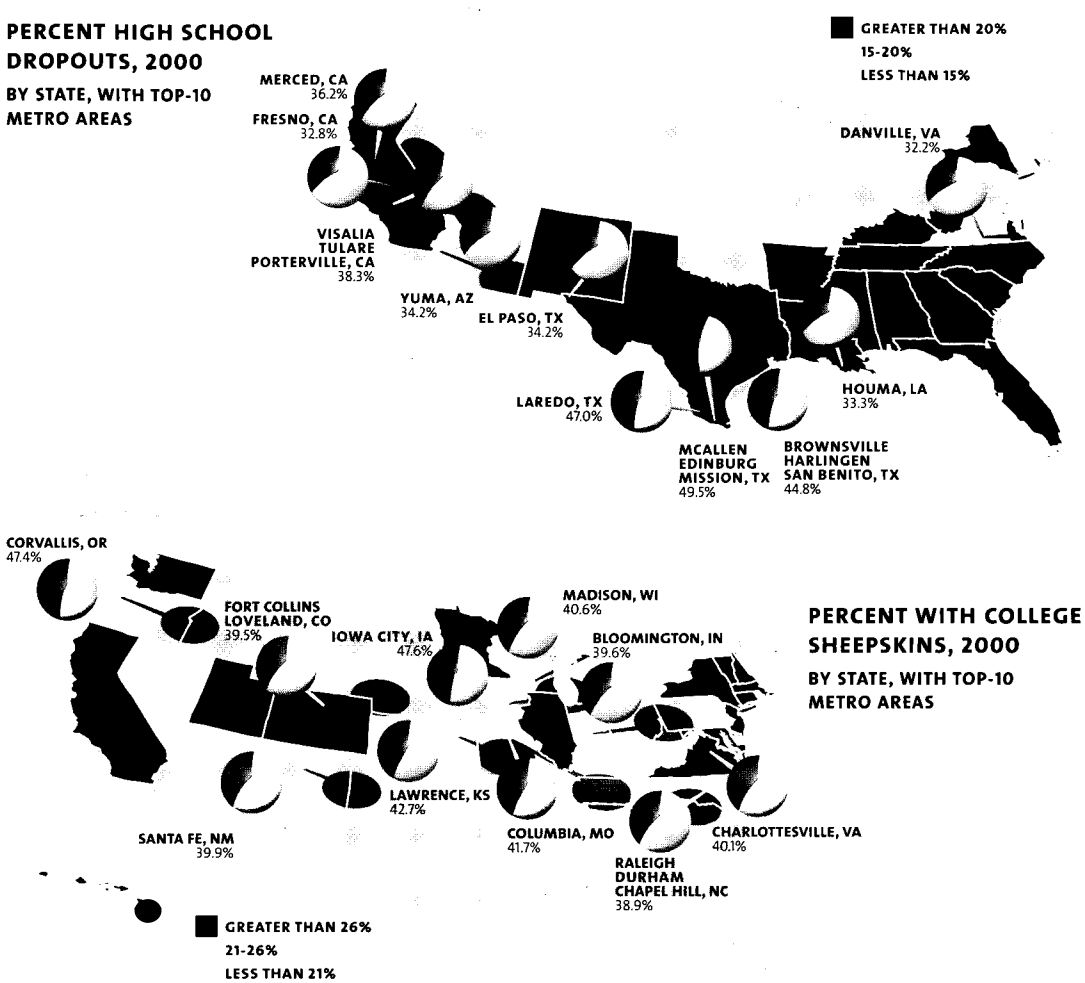

ALL CHARTS: BRUCE SANDERS AND MAX HARLESS

cleaners and the like. This creates the potential for local "barbell economies," with bulges at both ends of the education scale.

EDUCATION LEADERS AND LAGGARDS

In the District of Columbia, nearly four out of 10 residents have college degrees, while one in three are so blessed in Massachusetts. The comparable number for West Virginia is just one in seven.

Vestiges of the South's lag in education show up in its high proportion of high-school dropouts. In Mississippi, Kentucky and Louisiana, more than one out of four adults did not finish high school, compared to about one in eight in Minnesota, New Hampshire and Utah.

Not surprisingly, university towns – Iowa City, Madison, Charlottesville and Bloomington – are rich in grey matter. But college

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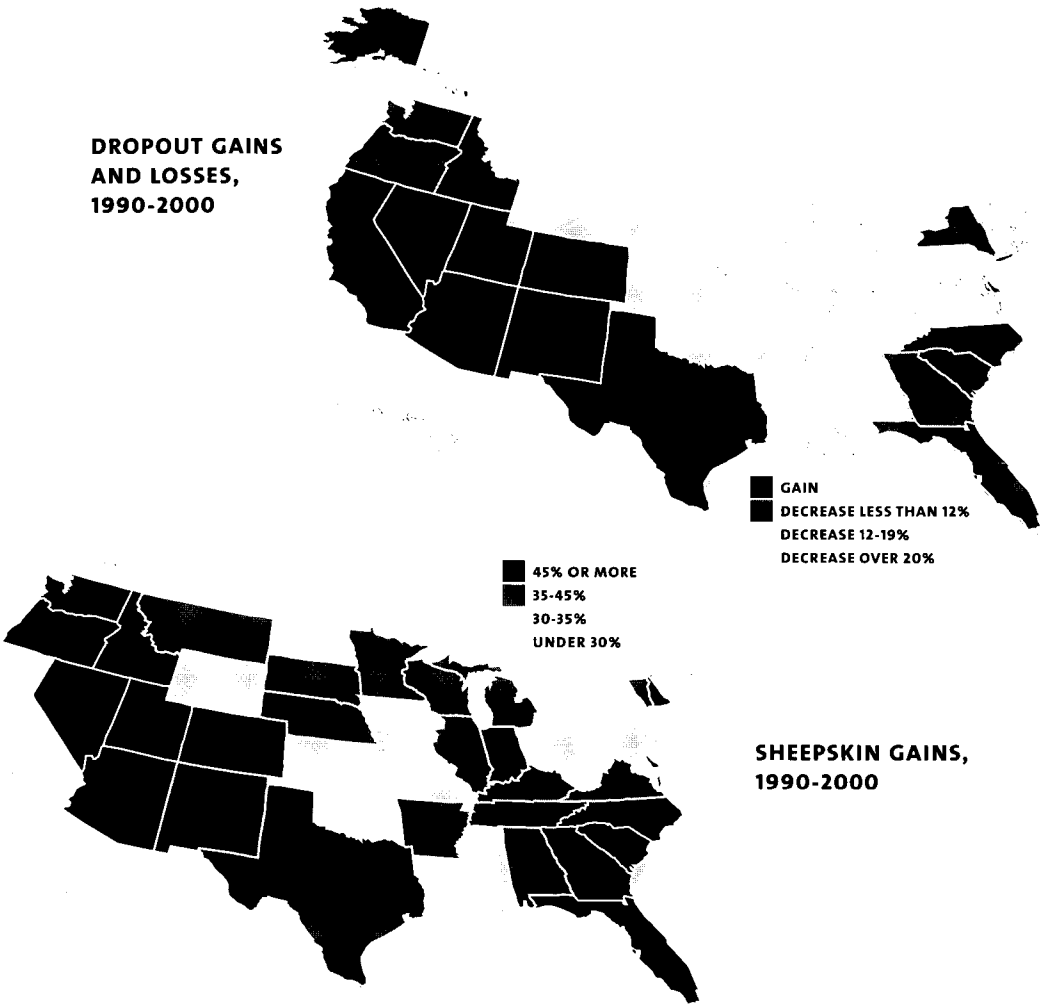
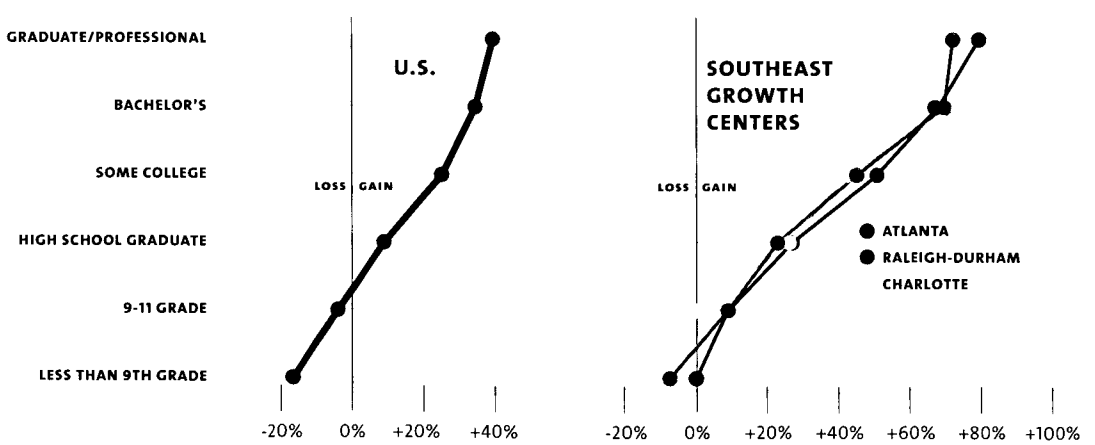


1990s SHIFTS BY EDUCATION LEVEL (PERCENT CHANGE)



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graduates shine in "new economy" metros, too – think Raleigh-Durham, San Francisco, DC, Austin, Boston and Seattle. At the other end of the spectrum, Latino border metros show large concentrations of dropouts – McAllen, Laredo, Brownsville and El Paso, not to mention Los Angeles and Miami.

SMART GROWTH

Migration of knowledge workers drove growth in the economically vibrant states of the Southeast and West. A good example is Georgia, which increased its college graduate population by 62 percent over the 1990s. Charlotte, Raleigh, Atlanta and Austin each increased their college graduate populations by more than 70 percent.

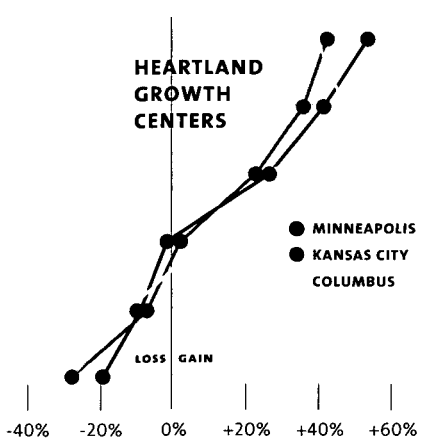
EMERGING "BARBELL" ECONOMIES

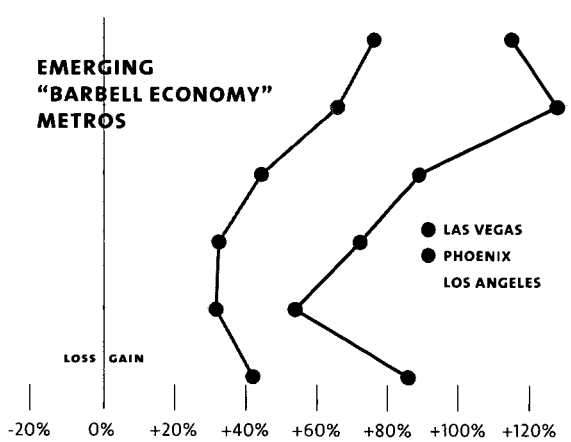
The nation as a whole showed a decline in high-school dropouts, but seven Western states plus Texas bucked the trend. The common thread: significant increases in Latino populations. Several states with dropout gains were also states with big gains in college graduates. The resulting barbell effect is even more pronounced in Las Vegas, Phoenix and other metros – a selective migration pattern long evident in the more mature gateway area of Los Angeles, which is a magnet to low-skilled service workers from Latin America.

BRAINS VS. BRAWN

I have calculated a "brains to brawn" index – the ratio of college graduates to high-school dropouts. Among the nation's largest metropolitan areas, a clear pecking order emerges. Minneapolis-St. Paul and Seattle have more than three college graduates for every high-school dropout. At the other extreme are barbell economy metros – Las Vegas, Miami, Los Angeles and San Antonio – where there are fewer college graduates than high-school dropouts. Low brains-to-brawn scores can also be found in a host of smaller metropolitan areas – some with new immigrant populations, others with aging native unskilled workers in the deep South and the Rust Belt. Indeed, about one-third of the nation's metros have more high-school dropouts than college graduates. It seems we're getting smarter all the time, but some places are getting smarter than others. M

BILL FREY is a senior fellow in demography at the Milken Institute.





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Fixing Corporate After Enron

By Robert E. Litan

Only yesterday, the American system of corporate disclosure was championed as a model for the rest of the world. Indeed, the Asian financial crisis of 1997-98, which was marked by revelations of a woeful lack of transparency in financial markets, led to a chorus of demands for the adoption of U.S.-style disclosure systems.

What a difference a metaphorical day makes. The number of American corporations whose earnings have been restated passed 200 in 1999. Numerous high-profile lawsuits have been filed against accounting firms for auditing failure, generating a number of multimillion dollar settlements. Nothing has done more, however, to generate concern about the adequacy of corporate disclosure than the failure of Enron last fall and news that its auditor, Arthur Andersen, knew about the company's problems beforehand, did not force their disclosure, and later shredded documents in an apparent effort to cover up its liability.

Many fixes have been proposed, and at this writing, some are being seriously considered by the Congress. But even as policymakers deliberate, the market itself is driving change. Corporate managers and directors are paying far more attention to disclosure, and some companies whose stock prices were hammered after Enron's failure (notably AIG, GE and IBM) have provided more details about their operations and risks. The various gatekeepers who failed so miserably in warning of Enron's problems – accountants, analysts, and ratings agencies – have also tightened up their practices. The New York Stock Exchange has issued far-reaching proposals for changes in corporate governance. And the SEC has been far more aggressive about pursuing accounting discrepancies.

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TOM NICK COCOTOS

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CORPORATE DISCLOSURE

What should government do? Not as much as some reformers have suggested, but more than many free-marketers want.

ACCOUNTING STANDARDS

Begin with the source of the financial problems that loomed in Enron's failure: large losses suffered by highly leveraged special-purpose entities that the company had created and effectively guaranteed. Under generally accepted accounting principles (GAAP), sponsors of these entities have been required to consolidate the assets and liabilities of the entities with their own unless outside investors contributed less than 3 percent of an entity's assets. Putting aside the cases where Enron appears to have misled its auditor about the proportion of outside investment, it is now clear that this 3 percent test was much too weak. The Financial Accounting Standards Board has since proposed raising the threshold to 10 percent, a move in the right direction. Even better, the FASB should put substance over form and mandate consolidation where (as in the case of Enron) the sponsor also guarantees the entity or otherwise effectively controls its operation.

The larger, more difficult issues relate to the standard-setting process itself. In particular, how should the twin problems of the FASB's general lethargy and the influence of interest groups be addressed?

The FASB's slowness could be tackled directly: Lynn Turner, the former SEC chief accountant, wants the SEC to impose deadlines on rule changes and act on its own if the FASB doesn't. The SEC could also speed things up by reviewing the FASB's rule-making agenda on a regular basis.

The downside to more active SEC involvement is that it could result in even greater political interference in the FASB. Witness, for example, the Congressional intervention that led the FASB to abandon its efforts to require companies to treat stock options as an expense at the time they are granted.

Arguably, politics is inherent in any rule-making process. Moreover, it can be reasonably claimed that setting accounting standards is not a science, and we should stop pretending that the process is independent of the interests of the profession that applies the standards and the firms that must abide by them.

Remember, though, that the main purpose of accounting standards for publicly held companies is to protect the investors, not the accountants or the firms' managers. Standards should help investors understand all relevant financial facts that make it possible to estimate future cash flows. Where the standards are changed or not implemented out of concern for firms, investors may pay the price.

In short, the issue is not how to keep politics out of rule-making, but how to prevent the process from favoring corporate interests over those of investors. In theory, putting more investors' or public representatives on the FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, a more balanced FASB couldn't stop it. By the same token, moving the standard-setting process to the SEC is not a panacea because it, too, is a creature of Congress.

Replacing GAAP with international accounting standards (IAS) set by the Inter-

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ROBERT LITAN is vice president and director of the economic studies program at the Brookings Institution, where he also holds the Cabot Family Chair in Economics. This article draws from analysis advanced in *Corporate Disclosure After Enron: The Big Picture*, written with George Benston, Michael Bromwich and Alfred Wagenhofer and forthcoming from the AEI-Brookings Joint Center on Regulatory Studies.

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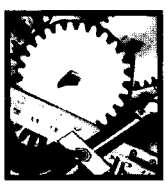
national Accounting Standards Board could help to solve the political-influence problem, since the accounting mandarins in London are likely to be less responsive to naked lobbying. As a bonus, uniform accounting standards worldwide would facilitate the cross-border movement of capital and perhaps even lower its cost.

But policymakers in the United States aren't about to let IAS replace GAAP. American firms would oppose the shift precisely because it would dilute their influence over standard setting. Similarly, U.S. regulators and legislators, not to mention the FASB itself, would most likely guard a continuing role for GAAP. And even if IAS were to replace GAAP, the single world standard could easily be fragmented in short order. The FASB might stay in business in order to interpret IAS for use here. Thus, over time, the FASB's rulings (as well as those of its counterparts elsewhere) would lead to multiple versions of IAS, resurrecting the disorder that now has many calling for IAS to replace GAAP.

There is a solution, arrived at by thinking out of the box. A core problem with any monopoly standard-setter is that it has no incentive to respond to market forces, let alone to resist political influence. As in private markets, the solution to monopoly is competition.

Competition could come in various forms. The most ambitious approach would be to let publicly listed firms choose one of the two main reporting standards now available – GAAP or IAS – provided they did not change standards for many years once they did choose. In principle, the same choice could be available for companies outside the United States. But, as a practical matter, this is not likely to happen. The European Commission already has decided that companies listed on European exchanges must report under IAS by 2005. Japan and many other countries are moving in the same direction.

Allowing firms to choose between the two standards would better insulate both the FASB and the IASB from undue political influence. That's because the standards they produced would be subject to a market test in which investors have the upper hand. Competition would also stimulate both standard-setters to keep pace with market developments, and thus help to cure the foot-dragging problem that has dogged the FASB – and that would very likely plague the IAS were it given a worldwide monopoly.



As in private markets, the solution to monopoly is competition.

To be sure, promoting competition in standard setting would mean some sacrifice in transparency, since investors would have to grapple with reports prepared under multiple standards. This should be less of a problem than it may appear, however, since private analysts would surely find it profitable to issue reports that translated the numbers.

Other forms of standards competition may be more politically feasible, although each would sacrifice some of the benefits of competition. One alternative, constrained competition, would allow firms discretion to choose a reporting standard only after a greater degree of harmonization has occurred between IAS and GAAP. To achieve this goal, both the IASB and the FASB could identify a few rules in which significant differences remain – such as revenue recognition, consolidation practices and stock options – and

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work to narrow them. Once these differences had been narrowed, but not necessarily eliminated, constrained competition could be launched.

Another alternative is mutual recognition, under which the United States would allow foreign companies reporting under IAS to list their shares on American exchanges without reconciling those reports to GAAP (as is now required under U.S. law), provided their host governments authorized listing of U.S. companies reporting under GAAP. This approach would stimulate competition between the two standards to only a limited extent, however, since it would preserve the monopoly status of both the FASB and the IASB in individual jurisdictions.

Still another alternative to unconstrained competition is to narrow the current reconciliation requirement. For example, instead of requiring foreign companies seeking to be listed on U.S. exchanges to reconcile their financial statements to GAAP in all respects, the requirement might be limited to reconciling only significant items, like the implications of different treatment of revenue, stock options, and consolidation practices.

Any of these alternatives would be an improvement over business as usual. But my preference would be for unconstrained competition, letting the chips fall where they may.

ENFORCEMENT

Of course, even perfect accounting standards can't protect investors unless they are enforced. And in light of the rising numbers of auditing problems culminating in Andersen's debacle in its audits of Enron, attention has wisely focused on how best to verify financial statements. Two basic approaches are mutually consistent and even mutually reinforcing: improved oversight of the auditors themselves and more finely calibrated incentives for those who conduct audits to carry them out properly.

Monitoring

The current system of overseeing the auditing profession – a combination of self-regulation and audit standard-setting by the American Institute of Certified Public Accountants along with supervision at the state level – is plainly inadequate. There is too much self-interest at the institute and its penalties are not credible, while state supervisors lack resources and expertise.

The most widely endorsed fix to the enforcement problem is the creation of a public regulatory board reporting to the SEC that would set and enforce auditing standards. At this writing, the House of Representatives has endorsed the proposal, but its fate in the Senate – where leading Democrats want to toughen the proposed board's investigatory powers and put more restrictions on accountants – is uncertain. If Congress does not create such a board before it adjourns for the midterm elections, it is virtually certain the SEC will do so on its own.

While a properly funded and staffed public regulatory board could certainly improve oversight of the auditing profession, one wonders why this is not a job for the SEC itself. The job of overseeing auditors is no more complex than overseeing the stock exchanges, investigating fraud or insider trading, or carrying out the rest of the SEC's statutory agenda. If the problem is lack of funding, there's an easy answer: Congressional appropriations, perhaps financed by user fees.

Some may argue that an independent board would be better sheltered from political interference than an internal SEC operation. But independence hasn't spared the FASB from such interference. The only plausible

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argument for creating such a board is the claim that the enforcement of auditing standards requires an understanding of the intent behind the standards; hence the two functions should be lodged in the same agency. And since no one wants to give the SEC authority to write auditing standards, that leaves the proposed board as the enforcer.

Yet many regulatory agencies write the rules they enforce, so in principle there is no reason why the SEC could not do both. If the SEC felt it did not have the requisite expertise to amend or to rewrite the auditing standards, it could look to the proposed board to write the first draft, then amend or bless the standards. Even if the SEC delegated the writing of audit standards to a new board, it would still retain oversight over the organization. In this capacity, the commission and its staff could be in regular contact with the board to clarify any possible misunderstandings over the meaning of particular audit standards.

The job of overseeing auditors is no more complex than overseeing the stock exchanges.

Better Incentives

Adding more and better cops to the beat is not the only way to improve auditing. Other steps may be cheaper and more effective. Auditors already have incentive to do their jobs, of course. They care about their reputations – and they certainly care about their liability exposure. Just ask the partners of Andersen, or of any the other Big Five accounting firms, who must fear that the same thing will happen to them. However, liability-based incentives can lead to overkill – to excessive caution as a reaction to the threat of going out of business. That's why more finely tuned incentives would help.

Another frequently mentioned proposal is to prohibit auditors from doing non-audit work for their audit clients. And some have suggested going further, limiting auditing firms only to audit work for all their clients.

The rationale for these various limitations, of course, is to remove auditors' incentives to compromise their role in the hope of gaining or holding onto lucrative non-audit business. In fact, all of the Big Five firms already have taken steps either to sell some of their non-audit businesses (notably, information technology consulting) or to forswear non-audit work with their audit clients.

Should these market-driven developments be enshrined in law? While there is a compelling case for preventing auditors from reviewing internal audit functions they perform, a broader prohibition is problematic. Even if audit firms were limited only to audit work, they would still face the prospects of losing their audit business if they disappointed clients – which in a world of restrictions would be the only business they have. As a result, audit firms could very well have the same incentives to compromise the quality of their work as they had before.

There are also reasons to be skeptical of another widely discussed proposal, the mandatory rotation of auditors every few years. Perhaps auditors who knew they were going to have their work scrutinized by successors would be more careful. But the opposite might be true: auditors might tacitly promise good treatment during the beauty contests that firms hold to choose their next auditors.

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In short, as long as management continues to choose the auditor, the potential will always exist for a conflict that compromises the quality of the audit. So the question becomes: who else could do the job?

It is tempting to solve the conflict problem by shifting the choice of auditors to third parties – to the stock exchanges, the SEC, or perhaps the proposed public regulatory board. But each of these alternatives would face numerous practical problems growing out of the fact that fully 12,000 public companies require audits. In principle, the assignments could be made through an auction, but a large bureaucracy would be required to administer that process. Also, in principle, the cost and complexity could be reduced if the rights to audit numerous firms were bundled. But who would do the bundling, and on what basis? Should firms found negligent in audits be allowed to bid for future audits?

Then there is the problem of ensuring that no single auditing firm (or group of smaller firms) effectively corners the market for audit services. One could impose market-share limits, but any deviation from neutral competition for audits would very likely invite political interference into the selection process.

A less radical way of relieving management of the discretion to hire and fire auditors is to assign the task to the corporation's board of directors. Indeed, although the House of Representatives refused to mandate this eminently sensible idea, the New York Stock Exchange has recently proposed that it be a requirement for listing on the exchange. The exchange also recommended that the directors' audit committees be chaired by someone with financial expertise, that no member of the committee receive compensation other than directors' fees, and that the committee meet separately with management and both internal and external auditors. These are all good, practical suggestions and represent about the best that can be done to align the incentives of auditors with those of shareholders.

BEYOND ENRON: FUNDAMENTAL PROBLEMS WITH THE CURRENT DISCLOSURE REGIME

Central to the functioning of all capital markets is the continuing flow of accurate, relevant and timely information. The Enron debacle reminded a number of well-known companies of this simple truth, when their stock prices plummeted because investors feared that they were not disclosing sufficient information to enable the market to understand their businesses.

However, the financial information that is now routinely reported and subject to audit is of limited (and decreasing) value for understanding the prospects of many companies. First, financial reports are inherently backward looking – a reality magnified by the fact that, for the most part, assets and liabilities are recorded at historical costs rather than at market value. To be sure, many analysts use earnings reports to extrapolate the future. But as the recent market turmoil has demonstrated, this can be problematic, since the future for many firms will not resemble the past.

Today, the future is largely what the analysts say it is, with firms under increasing pressure to hit or exceed analysts' earnings projections. For many firms, this pressure leads to the widely derided practice of earnings management.

Second, much of the value the market assigns to companies cannot be found on their balance sheets. This is because the relevant assets are intangible and cannot be easily traded in the marketplace independent of the company itself. Intangible assets include

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not only intellectual property – patents, copyrights, trademarks and trade secrets – but also the value of a company's work force, its customer base, its brand name, and all the other factors that contribute to its ability to generate earnings. Intangibles are important not only for high-tech companies, but also for many old-economy enterprises with unique production processes, highly trained work forces and loyal customers.

of a new computer language, XBRL, based on another more general language, XML, that allows firms to place "tags" or identifiers on all kinds of financial and non-financial information. With these tags, users can manipulate and rearrange firm-provided data in any manner that they see fit. This is simply not possible with the current HTML-based data that companies now release on the Internet.

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Third, nonfinancial information relevant to predicting the future may never directly show up in any financial report, and in any event may be generated more frequently than mandated quarterly disclosure reports. A few examples: the gain or loss of new customers, insiders' sales or purchases of the company's stock, changes in management and new patents. To its credit, the SEC has proposed that more such information be disclosed in so-called 8-K filings, and more rapidly (within 2 days rather than 5 to 15). In addition, companies are increasingly Webcasting their analysts' conferences on the Internet so that anyone can listen in. Under the SEC's new Regulation FD companies may not give analysts information that is not simultaneously made available to the public.

Fourth, new computer-based technologies, especially the Internet, may soon make it possible for investors to crunch company-specific data on their own so that they need not rely on GAAP-based financial statements. Of special significance is the development

In short, by their very nature, GAAP-based financial statements are limited in the kinds of information they provide and on what schedule. The critical challenge for firms, their accountants, the investing public and policymakers is to accommodate this broader, less-well-defined need for timely disclosure.

DISCLOSURE FOR THE FUTURE

Begin with intangibles. One response is to require firms to put values on intangible assets, and perhaps even to estimate how those values might change over time and translate the changes into income. This is not practical, however, because there are rarely organized markets for intangible assets, and thus no objective way for auditors to verify the numbers.

A more productive approach is for firms to disclose more nonfinancial information that may change intangible value. That might include information about consumer or worker satisfaction, product quality, innovation, education and experience of the work force and of management. The SEC should

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use its powers of persuasion in this area, perhaps by convening industry working groups to encourage firms to make more such disclosures, and to do so consistently and regularly.

A second policy challenge is how best to harness technology – computers and the Internet – to facilitate more complete, more rapid corporate disclosure. Once the XBRL-based tags are fully developed and implemented by companies, a wide range of users – not just sophisticated ones like financial analysts – will be able to take detailed data and reconfigure it in multiple ways, using widely available spreadsheet programs.

Here, too, there is a role for the SEC in the bully pulpit, encouraging companies to participate in developing tags for information and publicizing their value to investors. The SEC may also want to consider specific ways to encourage companies to use the tags at the earliest date practical. One possibility: require documents that are required to be submitted as electronic data to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting. Many companies now have, or will soon have, the ability to make available their financial reports available on a weekly, if not daily, basis. (Indeed, financial institutions already typically balance their books every night.) Why not consider ways to have this financial information communicated in the same time frame?

There will be objections to encouraging companies to make unaudited financial information available more quickly, but these can be met. Quarterly financial data is currently unaudited and will remain that way unless the SEC or a new public regulatory board comes up with guidelines for more limited audits of frequently reported data. In any event, even in the wake of Enron the financial data produced by the overwhelming preponderance of public companies is still useful. Accordingly, if in an age of computers and the Internet companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

There may be a side benefit to more frequent financial disclosure. If companies routinely reported their financial results much more frequently, investors and analysts might be freed from their obsession with the quarterly numbers. It is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a chance that more frequent reporting could reduce incentives for managers – and their auditors – to engage in earnings management.

But mandating more frequent reporting at this point is premature. Many firms simply wouldn't be able to comply with such a requirement, even covering periods as long as a month. Or the cost of compliance might be prohibitive. The challenge is to find a way to provide incentives to the firms that are able to report more frequently than quarterly to do so. Here, too, the SEC could be leading a visible campaign to encourage the rapid reporting suitable to the Internet age.

FINAL THOUGHTS

Pessimists worry that policymakers won't do enough, soon enough, to rectify the problems in the United States disclosure system that Enron (and previous accounting scandals) have revealed. I am more optimistic. Markets have already done a lot of self-correction. My hope is that policymakers will think more boldly, embracing a competition-based approach to accounting standards while pushing regulators and the private sector to disclose more nonfinancial information.

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The Other Social Security Solution

by David A. Levine

Imagine *the human genome project succeeding beyond our wildest dreams. By the middle of the next century people typically live – healthy and vigorously – to the age of 200. They go to school until they are 20 and work until they are 65, leaving 135 "golden years" for golf, pinochle and reading the* Bhagavad Gita *in the original. In the meantime, compensation for workers – i.e., wages plus what employers pay in Social Security taxes – rises 50 percent from today's levels and averages approximately $51,000 per year. The federal and state income taxes levied on this are only $5,000. Medical science has not only accomplished everything we could have hoped for, but has done so cheaply; health care costs per retiree per year absorb the same fraction of national income that they did in 2002.*

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Life, especially retirement, sounds wonderful. But there's a problem. People are living so long that the ratio of retirees to workers has risen tenfold to three retirees for every person gainfully employed. Medicare taxes alone have reached $11,000 per worker, leaving just $35,000 to support each worker and all the non-medical needs of three retirees. The Social Security Commission of 2025 tried to handle the demographic overload by setting taxes at a level that provides retirees half of the after-tax income of workers. As a result, Social Security taxes paid by employees and their employers have ballooned to an average of $21,000 per year, but give the typical retiree just $7,000 per year and leave the average worker with take-home pay of only $14,000. Everyone lives a long, healthy life – but almost everyone is poor. The old adage, "if you have your health, you have everything," has been inverted: "everything you have is your health."

Although we will not stretch life to two centuries anytime soon, this fable points to a very real and widely recognized problem: the retirement of the baby boom generation, which is coming at a time of rapid increases in life expectancy, threatens to compromise everyone's standard of living. By 2016, give or take a year, Social Security tax receipts will no longer sustain the benefit structure to which we have become accustomed.

The final report of the President's Commission to Strengthen Social Security, co-chaired by former Senator Daniel Patrick Moynihan and AOL Time Warner Chief Executive Officer, Richard D. Parsons, recognized that "demography is a kind of destiny," and concluded that all of the paths to fiscal sustainability "require some combination of changing the rate of benefit growth or committing additional revenues generated by taxation or by the proceeds of investment." Since higher taxes have been ruled out by the president – and may well be unacceptable to the public – the remaining choices, according to the Commission, consist of (1) cutting benefits, (2) betting on investment success, or (3) some combination of the two.

The Commission floated three "reform models" that, in varying degrees, would reduce conventional Social Security benefits while attempting to make up for the shortfall via the performance of personal accounts. Two of the three models fund the personal accounts by redirecting Social Security taxes into portfolios of stocks and bonds. The third supplements these redirected payroll taxes with voluntary private contributions.

In light of population trends, it is clear that something must be done. But the report is misleading when it claims to have identified "all" the possible solutions. Having recognized that demographic exigencies are the source of the problem, the commission ignores the obvious demographic solution – namely, postponing retirement. Since we are living longer and healthier lives, we could solve the entire problem with little trauma by working several more years. By delaying retirement commensurate with gains in longevity, benefits could be maintained without raising taxes because the ratio of workers to retirees would remain high enough to cover the bill.

Furthermore, there is good reason to believe that the Commission's proposed solution – partial privatization of Social Security – *could not* succeed. It is not possible for *both* workers and retirees to remain as well off as they would have had birth rates and life expectancy not changed. Just as a family with

DAVID A. LEVINE was formerly the chief economist at Sanford C. Bernstein & Co., Inc.

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$50,000 in income and three kids (young dependents) cannot be quite as well off as a family with $50,000 in income and two kids, a *society* must be worse off when the number of retirees (old dependents) per worker increases by 50 percent. If the personal accounts under a revised Social Security system do poorly, retirees will suffer a reduced standard of living. If this investment component does well enough to sustain retiree benefits at or above what the current system would provide, the standard of living of workers *must* suffer unless the plan also magically raises the pace of GDP growth.

Of course, raising the retirement age represents a sacrifice as well. But it is the only way to allow the standard of living for both workers and retirees to continue to improve as expected.

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THE LOTTERY PARADOX

Economists like to remind everybody that there is no such thing as a free lunch. The lottery winner's early retirement is paid for by those who bought losing tickets; the insurance settlement for the accident victim comes from premiums paid by policyholders; public schools, welfare checks, firehouses and Social Security are all underwritten by the taxpayer.

But what if we all woke up tomorrow with 10 times as much money in the bank – lottery winners all? Could we all retire? Clearly not, for if everyone retired, no one would be producing anything; we'd all have a great deal of money but nothing to buy with it. And if we all kept working, we still wouldn't be better off. We'd have 10 times as much money, but the total quantity of goods and services being produced would be unchanged and, thus, so would our standard of living. Only prices for goods and services would be proportionately higher.

This underscores a key paradox: An individual, family, company or group (e.g., retirees) that gets more money is better off, but, if *everyone* gets proportionately more money, the only consequence is inflation. The only way to make the economy as a whole better off is to increase production.

By the same token, the performance of the stock market cannot solve any society-wide economic problems. In the second half of the 1990s, stock market returns averaged almost 29 percent annually and, by the end of 1999, Americans owned $18 trillion in equities. If that body of wealth had continued growing at the same rate, it would have shot past $300 trillion sometime in 2010 – a hefty $1 million per capita. Couldn't we all retire then?

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This is like the everybody-wins-the-lottery example. If we all retired there would be no food produced, schools staffed, cars built and so forth. The value of monetary wealth is not intrinsic; it lies in its ability to gain command over real output.

The problem is not financial; in the not-too-distant future we will simply have too many old people dependent on the support of too few workers. The only solution that does not entail lowering someone's living standard is to change that ratio. No amount of fiddling with financing mechanisms or trust funds, no amount of investment success (in a privatized or partially privatized system), no increase in the savings rate and no amount of budgetary legerdemain can change that fact. Both the necessary and sufficient ingredient to a few-tears solution to the problem of Social Security is to raise the retirement age.

RAISE THE ROOF

To be sure, part of the demographic problem stems from the lowered birth rate of recent decades. With birth rates at or below replacement rates since the 1970s, the traditional population pyramid is destined to become a rectangle – it will even have a slightly *inverted* pyramidal shape for a while. But it is doubtful – for various reasons – that a higher fertility rate is desirable and, in any event, just as doubtful that government incentives could boost it significantly. Compounding the problem, fewer workers die before retirement. The "perfect" worker from a government bean counter's perspective is one who labors his whole life – making tax payments all along – and then drops dead the day he retires. When Social Security began, those reaching the age of 65 represented only 57 percent of those who were in the work force 44 years

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earlier. Thus, one could expect that many workers would pay taxes into the Trust Fund – i.e., help support people who had already retired – yet never themselves receive any benefits. Today, 80 percent of workers make it to 65, and this figure will likely exceed 90 percent within a generation.

Of course, those who reach retirement age also live longer. In 1940, life expectancy at age 65 was 14 years; today it is 18 years, and rising rapidly. This, of course, is a happy development. But from a Social Security perspective it only exacerbates the declining ratio of workers to retirees.

If raising the retirement age is such an obvious solution, why don't the experts recommend it? My guess is that those who have considered this idea have refrained from promoting it because they believe their political patrons wouldn't consider it. And the politicians who have heard of the idea may have rejected it, believing the public wouldn't stand for it. Not that we know such a plan would be unpopular. If the public fathomed that our *only* choices consist of (a) raising taxes, (b) cutting benefits, or (c) raising the retirement age, it might well prefer a solution that depends on a few more years in harness.

Actually, this idea has been lurking in footnotes to the Social Security debate for more than 20 years. Indeed, legislation sparked by the 1982 Greenspan Commission Report scheduled a rise in the retirement age to 66 by 2009, and to 67 by 2027. But this two-year increase over 44 years – which was quite a bit less than suggested by the Greenspan Commission's actuaries – won't be sufficient to keep pace with the advance in life expectancy during that period, let alone make up for the demographic imbalances that had already developed by 1983 and the increase in life expectancy that can be expected after 2027.

What does the Bush/Moynihan/Parsons Commission to Strengthen Social Security have to say about increasing the retirement age further? Not one word.

Unable to decide on a single proposal, the Commission offered three models, all centering on personal retirement accounts that would be invested in broadly diversified portfolios of stocks and bonds. Unlike the nontransferable retirement benefits workers receive as entitlements under Social Security, workers would *own* these accounts and could bequeath them to anyone they wish. Participation would not be mandatory, but all three plans would entail a reduction in guaranteed future benefits for non-participants.

Under Model 1, workers opting not to participate in personal accounts would enjoy benefits equal to those provided under current law – but only until the money in the Trust Fund runs out in approximately 35 years. Benefits would then collapse unless Congress chose to raise taxes or appropriate funds from the broader budget. Under Models 2 and 3, the reduction in guaranteed benefits for those staying with the traditional system would be more gradual – but it would begin much sooner (2009 under Model 2, and immediately under Model 3). Interestingly, the reduction in benefits under Model 3 is scaled to increases in longevity, and the proposal includes a benefit hike for those who delay retirement. However, rather than taking the next logical step, the Commission would explicitly create these incentives "without changing the retirement age."

PUTTING OUR STOCK IN STOCKS

The Commission, of course, hopes to sell the program – and to save the system – with the carrot of improved investment returns rather than the stick of lower benefits. Those who invest in the new personal accounts could, in

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the Commission's words, "reasonably expect to receive [benefits] greater than the future benefits payable under the current system." But this assumes that benefits under the current system would be reduced at some point in the future owing to a shortfall in payroll tax receipts – and that private investment returns would be as high as projected.

Regarding those projections, the Commission contends it is being conservative in assuming that stock market returns will beat inflation by 6.5 percent annually, trumpeting the fact that the real return from 1926-2000 averaged 7.75 percent. But the Commission managed to ignore the dismal returns after the end of 2000 that lowered cumulative equity returns to less than 7.5 percent by the time the Commission's report was published, and which stand around 7.3 percent as of this writing.

Meanwhile, if historical returns are relevant, why detail the historical record for stocks, but conceal the history of bonds? Their bond projections are about 1 percent *above* those posted during the same historical period. Is the Commission unaware of how bonds have done, or is it just picking and choosing which statistics to present in order to strengthen its case? If we look at past performance of *both* stocks and bonds, the Commission's projections are, on balance, not conservative at all; they are in line with historical performance since 1925. In any event, it is debatable whether historical results – even over lengthy periods – are a reliable guide.

To see how misleading historical averages can be, consider the 53 years from August 1929 to July 1982. Stocks beat inflation by just 3.8 percent per year, less than half the 75-year average cited by the Commission. Admittedly, I'm the one being selective here – this was the worst long-term experience in the U.S. in the 20th century. Results were relatively poor because it starts at the top of a great bull market and ends at the bottom of a deep bear market. But 53 years cannot be dismissed as a short-term aberration. This experience would have ruined several generations of retirees, had they banked on 6.5 percent returns.

Moreover, it is not as if there exists a large sample of 50- or 75-year histories that proves that 1926-2001 is more representative of the future than 1929-1982. We have excellent data going back to the 1920s and just sketchy data for 50-125 years before that. So there is no statistically meaningful historical sample suggesting that stock returns over the *typical* 75-year period will beat inflation by 6-8 percent.

At this writing, stocks are selling at more than 40 times current, recession-depressed earnings – perhaps 30 times "normal" earnings – and dividend yields are less than one-third their historical average. As such, I think

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equities will do well to beat inflation by as much as 3-4 percent over the next generation. Of course, the Commission's optimism may prove warranted. But, right or wrong, it ignores at *our* peril the broker's classic fudge: past performance is no guarantee of future results.

Note, too, that the personal accounts may prove much less popular than the Commission presumes. It emphasized that 52 percent of all U.S. households own mutual funds, and that, as of 1999, more than 70 percent of the assets in 401(k) retirement plan portfolios were invested in equities. But these statistics might reasonably be interpreted the opposite from the way the Commission suggests. After all, all these people know that not a penny of their Social Security taxes are channeled into the stock market, yet 48 percent of households own no mutual funds whatsoever and 30 percent of 401(k) assets are not in equities. If the public does not embrace personal accounts to the extent the Commission expects and the shortfall is significant, the reform will be dead on arrival.

But even if (a) everybody signs up for investment accounts, (b) everybody deploys their assets as the Commission expects (i.e., 50 percent equities), and (c) the Commission's projections for investment results are attained, benefits would still eventually decline, compared with what could be expected under current benefit schedules, for virtually all workers under Models 1 and 2. Under siege from demographics, the Commission has surrendered – giving up on those who don't volunteer for personal accounts and merely *hoping* that those who do will not fare too much worse than would be expected under current benefit schedules.

Model 3 does better because it supplements the reduction in guaranteed benefits with "a voluntary contribution of an additional 1 percent of the participant's wages" – a contribution partly subsidized out of general revenues with a tax rebate for low-income workers. For those who elect to participate, the 1 percent is matched by a 2.5 percent contribution (up to $1,000) diverted from current payroll taxes. Model 3 also increases the penalties for retiring early and the rewards for retiring late.

Model 3 dodges the president's prohibition of tax increases by making the individual contributions "voluntary." But voluntary contributions could just as easily be used to bolster retirement finances through liberalization of IRA or 401(k) rules. And in any case, it doesn't really solve the economy-wide problem – namely too few workers relative to the number of retirees.

RETIREES OF THE WORLD UNITE

Imagine, for the moment, that the Commission's assumptions are easily met. Almost

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everyone opts for personal accounts, the vast majority put most of their money into the stock market, and the markets produce even better returns than they did in the past. This combination of developments allows benefits to equal or exceed those projected under the current system, no matter which model is adopted.

Nirvana? Not quite.

What we have here is a variation of the bull market scenario cited earlier (where per capita wealth reached $1 million). The reader will recall that it cannot work for both workers and retirees because what we think of as *financial* security for society as a whole is actually *economic* security and is rooted not in financial assets, but rather in the real output of goods and services. Since the stock market doesn't produce anything, it cannot yield the goods and services that would permit people to comfortably retire at 65 (or, later, 67) as life expectancy grows. If we don't have enough people working or productivity doesn't go through the roof, there will simply not be enough economic output to satisfy the needs of retirees and workers.

To be sure, if we partially privatize under any of the three models, and the stock market posts high enough returns, it is mathematically possible for retirees to remain quite comfortable even as their population swells. But this would have to mean that workers would trail behind. At any given level of productivity, the size of the economic pie is limited by the total number of people working. If retirees have great financial resources, they would be able to outbid workers for the limited supply of goods and services. In short, retirees would remain comfortable at the expense of workers.

Alternatively, if stock and bond returns are below the Commission's projections, retirees will suffer economic hardship while workers do just fine. Both groups cannot do well unless the real output of the economy grows commensurate with the population.

German Chancellor Otto von Bismarck proposed the world's first public pension system in 1881. Adopted in 1889, it stipulated a retirement age of 70 because by that stage most workers were unable to work. As it happened, industrialization generated such outsized gains in productivity over the next generation that – despite advancing life expectancy and its embroilment in World War I – Germany was able to afford a 65-year-old retirement age by 1916 without unduly taxing workers or depriving retirees of adequate benefits.

In 1935, when our own Committee on Economic Security proposed a retirement age for the U.S., the members also settled on 65. This decision was not based on the European model, but on the retirement age already in place for various state and private systems, as well as for federal railroad employees. Actuarial studies at the time suggested that a

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retirement age of 65 could be supported by a level of taxation that would not impose too much of a burden on the labor force.

Now, 86 years after Germany adopted a retirement age of 65, the retirement age in the United States is – well, 65. The two-year increase scheduled for the next 25 years will mitigate, but not prevent, a crisis. The fact is that when a retirement age scarcely changed from 1935 collides with the demographics of 2035, the results will be calamitous.

Greater longevity was destined to make retirement at 65 (or 67) untenable sooner or later. But it's going to cause problems sooner because of the collapse in births. The average number of children per woman peaked at 3.7 in the late 1950s and is now just over 2.0 – i.e., replacement level.

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THE CURSE OF LONG LIFE

Ironically, most of us are hoping for developments that would make Social Security system finances even worse. I am referring, of course, to advances in longevity that might arise from the human genome project and other biotechnological initiatives. Life expectancy at age 65 – which increased from 14 to 18 years over the past six decades – is presumed to advance "only" to 21 years by mid-century. The actuaries are clearly assuming that the spectacular medical technologies now in sight will fail to change the trajectory of these advances. That may not be a safe bet.

Currently there are 3.4 "covered" (i.e., tax-paying) workers for every person receiving Social Security benefits, and the Social Security Trust Fund is running a surplus of about 20 percent of expenditures. Indeed, if there were "only" 2.8 covered workers for every beneficiary, they would pay enough taxes to cover the Fund's annual expenditures. The problem is that this demographic cushion is likely to

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disappear in less than 15 years.

By 2030 – despite the fact that the normal retirement age will have risen to 67 – the ratio of covered workers to beneficiaries will have dropped to 2.1:1 and expenditures will exceed revenues by 32 percent. To close that gap, three options are available. We could raise the payroll tax rate from 12.4 percent to 16.4 percent, cut benefits by 24 percent, or reduce the number of beneficiaries by 18 percent (which would require an increase in the retirement age to approximately 70). Note that the number of beneficiaries need decline just 18 percent – instead of 24 percent – because that reduction entails a simultaneous increase in the number of workers/taxpayers contributing to the system.

The Commission is proposing to solve the crisis in Social Security by instituting a system of personal accounts that it believes will lead to only a moderate reduction in benefits under two of its proposals and a modest increase under the third. Yet, unless substantial gains in the stock market are mirrored by equally substantial gains in productivity and economic growth, retirees can only hold their own at workers' expense.

Might it make better sense simply to cut benefits (by 2030) by the 24 percent or so that the demographics would require if we don't raise the retirement age? This might be a reasonable option if there was a consensus that benefits were too generous.

Although the formula for calculating benefits has changed over time, they have always borne some relationship to the amount of

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taxes individuals have contributed to the Social Security Trust Fund. Currently, benefits are based on a worker's best 35 years' earnings (adjusted for wage inflation), but with a fairly progressive tilt. The average monthly benefit (for a single retiree) is around $874; if you earned the minimum wage for the past 35 years, your monthly benefit is just 20 percent less.

There was a time when benefits were lower than this, compared to average wages. Since 1975, increases in retiree benefits have been tied to increases in the Consumer Price Index. But before 1975, there were many increases that were considerably greater than the rise in the cost of living.

Arguably, this was the right thing to do. After all, the original benefits were modest, American productivity growth was strong, and there was an implicit political consensus that we could afford to do better by the old folks. Between the time the first Social Security payment was made (January 1940) and June 1974, the increases conferred on retirees exceeded inflation by 49 percent. Comparable increases were made to the formulas that determined initial benefits.

Had these increases never taken place, there would be no crisis in Social Security; benefits would be about one-third lower. On the other hand, without the increases, the majority of single retirees and about half of retired couples would not have sufficient income to remain above the poverty line. The typical individual today receives only $10,500 per year, while the typical couple gets $17,500.

The Commission correctly points out that none of its proposals would reduce inflation-adjusted benefits; instead they would reduce the growth in inflation-adjusted benefits compared to how they would increase under the current system. In other words, benefits would outrun inflation – but by less than is currently scheduled. What's so bad about that? The answer is that, throughout our history, increasing labor productivity has enabled our economy to grow quite a bit faster than the population, resulting in an ever-higher standard of living for both workers and retirees.

When a particular group's standard of living advances, but does so much more slowly than that of the general population, it eventually ends up being considered "poor" – even if it is actually better off in absolute terms. Many poor people today own automobiles; almost all have TVs. These were once considered luxuries. But, if the reader thinks this represents decadence, he should consider life without indoor plumbing, which was a luxury less than a century ago.

Work is not such a terrible thing. It is certainly far less dangerous and physically demanding today than just a half-century ago. In a world with greater life expectancy, society has less obligation to support the living standards of 65-year-olds who chose not to work. Retirement at 65/67 could certainly remain an *option*, but with benefits discounted sufficiently that they can be supported by the current tax structure.

The Bush/Moynihan/Parsons Commission's attempt to finesse the problem by banking on the stock market is almost certainly doomed to failure – quite possibly for both retirees and workers, but certainly for at least one of the groups. If we reduce benefits, retirees will suffer; if we raise taxes, workers will suffer. If we bet on the stock market, *at least* one of the groups will suffer unless productivity grows much faster than can reasonably be anticipated. But sadly, the hollow promises of partial privatization continue to occupy center stage in the debate. ■

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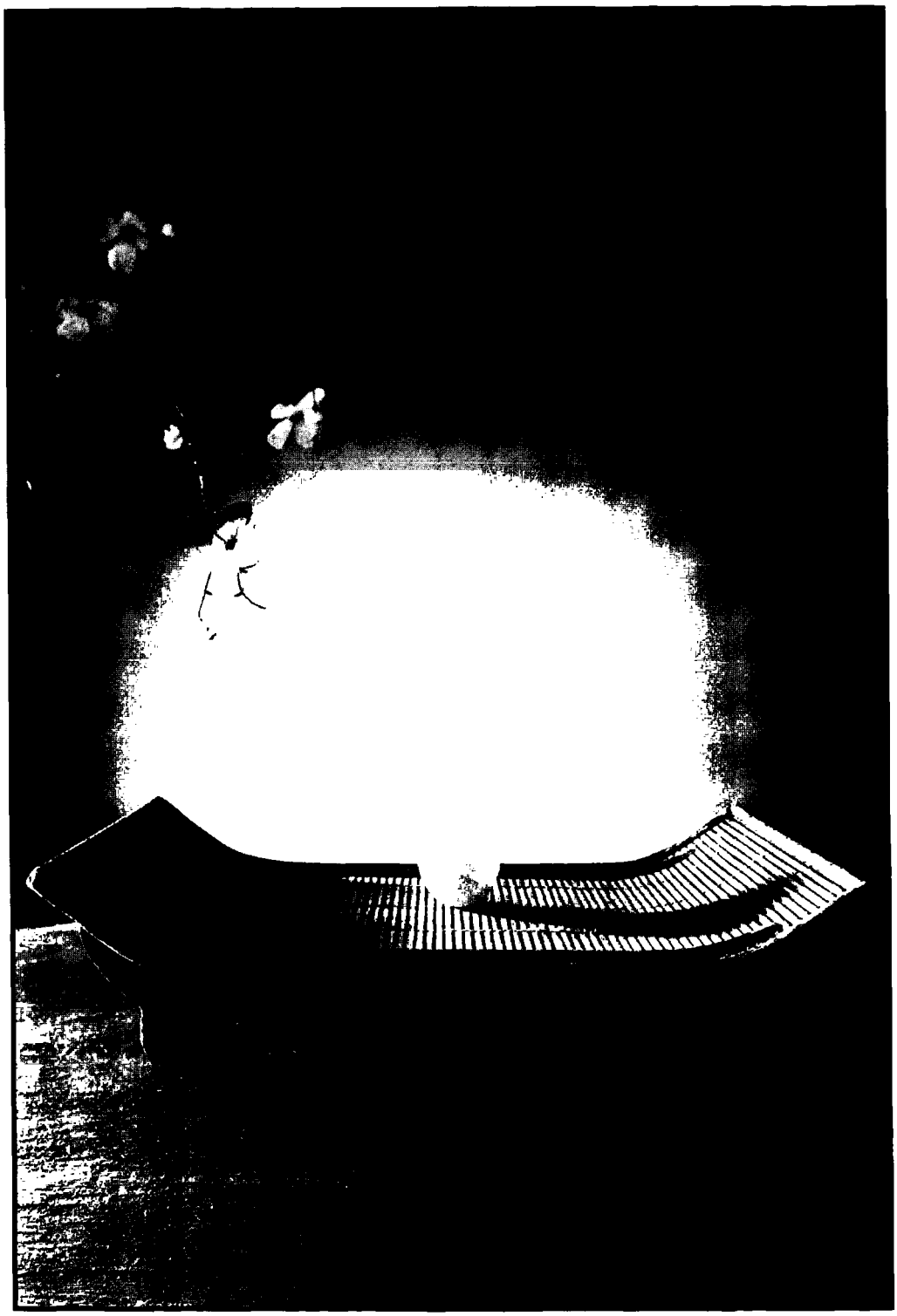

BRUCE WELLER

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a banking crisis: reformers do not reform. blame is difficult.

by Gavin Buckley

By everyone's reckoning, the Japanese economy is in wretched shape.

It shrank at an annual rate of 3.4 percent in the second half of 2001, experiencing the fourth recession in a decade, and the Organization for Economic Cooperation and Development expects unemployment to exceed 6 percent this year. Indeed, the only reason that forecasters are expecting growth to turn positive in 2002 is an upturn in demand from abroad. What's more, the shadow of deflation over the Japanese economy is growing darker: prices are expected to fall at an annual rate of 1.6 percent in the second half of 2002. ¶ Everyone also agrees that the Japanese banking sector is both a cause and a victim of this macroeconomic malaise. The banks are hamstrung by poor-quality assets and a lack of capital, and are therefore unable to perform their critical role as intermediaries between savers and businesses seeking capital. Yet without substantial economic growth in the economy, the banks cannot possibly outgrow their problem loans. The major banks expect to report combined credit costs of 6.4 trillion yen (¥) in the fiscal year that ended in March 2002 in contrast to operating profits of only ¥3.5 trillion in the previous fiscal year. Thus, one way or another, the gridlock can only be broken by government intervention. But here the consensus

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ends. Discussions about the form that government support should take and the means by which it should be delivered often center on Japan's Resolution and Collection Corporation. While the RCC has often been likened to the Resolution Trust Corporation, which was instrumental in resolving the savings and loan crisis in the United States, neither the RCC's bureaucracy nor the government that defines its mandate offers much hope of a fix anytime soon. Indeed, one could argue that the people in charge of resolving the banking crisis have little to gain and much to lose in getting the job done.

WHEN IN DOUBT, MERGE

The Resolution and Collection Corporation was created on April 1, 1999, through the merger of the Housing Loan Administration Corporation (HLAC) and the Resolution and Collection Bank (RCB). The former had been created three years earlier from the assets of seven failed *Jusen*, or housing loan corporations. The *Jusen* were established in the 1970s as mortgage finance companies financed by parent depository institutions.

In the 1980s, their focus switched from financing housing to financing more speculative real estate and property companies, which were used by their parents to evade controls that were put on bank property lending during the run-up of asset prices in Japan's infamous "bubble" economy. Thus, *Jusen* were among the first financial institutions to fail when the bubble burst in the early 1990s.

GAVIN BUCKLEY is an economist in the U.S. Treasury's Office of International Banking and Securities Markets. This article does not necessarily reflect the views of the Treasury Department or the Office of the Comptroller of the Currency. The author may be reached at <gavin.buckley@do.treas.gov>.

The Housing Loan Finance Corporation was created from the failed *Jusen* with notional assets of ¥13 trillion. These assets are usually referred to as having been "purchased" by the HLAC. In fact, the establishment of the HLAC really amounted to a forced merger of the failed institutions – one facilitated by an infusion of ¥680 billion from the government and a forgiveness of ¥5.7 trillion by the *Jusen*'s parent financial institutions. Some ¥6.4 trillion of the total *Jusen* assets of ¥13 trillion were deemed to be uncollectible.

Kohei Nakabo, a lawyer and former president of the Japanese Bar Association, was installed as the HLAC's director. He made it quite clear that the quasi-public corporation's focus was debt collection, and pledged to avoid further losses that would necessitate further outlays of public funds. (The *Jusen* Law obligated the government and the *Jusen* parent companies to cover the future losses of the HLAC portfolio.) However, since the *Jusen* assets were valued based on the 1995 land price index and land prices continued to fall, additional losses were inevitable.

Traditionally, the Japanese government has dealt with bank failures before the formal event by arranging mergers with stronger institutions. By the mid-1990s, however, the weak economy and continuing declines in real asset prices brought so many financial institutions to the brink that the remaining ones had neither the stomach nor the balance sheets to absorb them.

In 1994, a number of credit cooperatives failed. The two largest were reorganized in January 1995 as the Tokyo Kyodo Bank, capitalized by the Bank of Japan and various Japanese commercial banks. Kyodo Bank was not a success. More credit cooperatives failed, and in November of that year the Ministry of Finance announced that Kyodo Bank would

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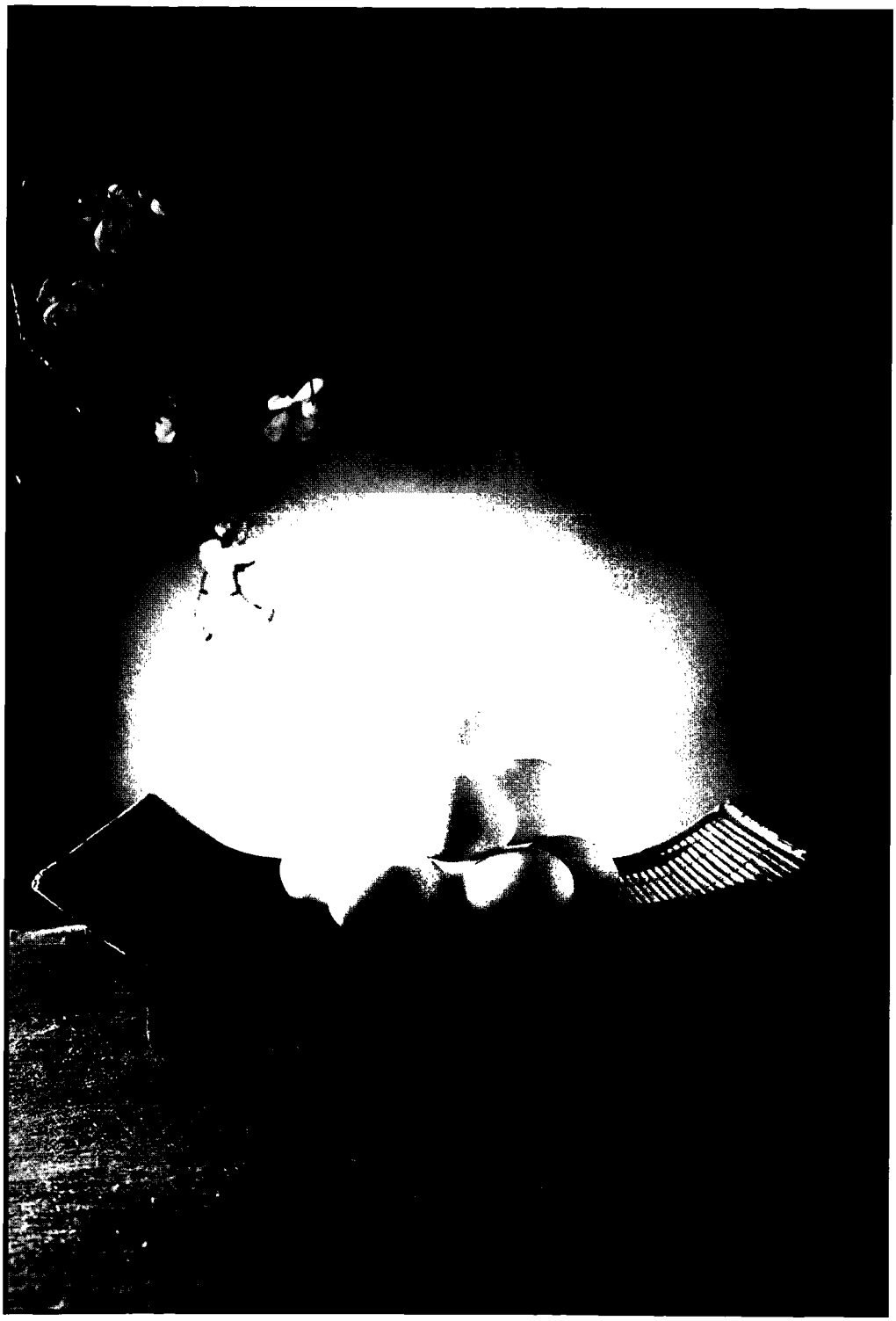

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again be reorganized into a receivership institution for these failed cooperatives.

Nothing succeeds in Japan like failure: in September 1996 the Kyodo Bank was once again reorganized, this time as the Resolution and Collection Bank (RCB), with a mandate to act as the receiver for *all* failed depository institutions. The RCB could assume assets from failed institutions for a period of five years, with the requirement that all assets were to be collected or otherwise disposed of within 10 years.

OFFICERS OF THE RESOLUTION AND COLLECTION CORPORATION (AS OF AUGUST 1, 1999)

	PRESIDENT	VICE PRESIDENT	SENIOR DIRECTORS	DIRECTORS	AUDITORS	TOTAL
Lawyers	1		3	1		5
Ministry of Finance		1	3		2	6
Bank of Japan		1	1	2	1	5
Police authorities				1		1
Private banks		1	4	9		14
National Tax Agency				3		3
Ministry of Construction				1		1
Private industry					1	1
TOTAL	**1**	**3**	**11**	**17**	**4**	**36**

As 1997 progressed, increasingly larger regional banks failed, culminating in the failure of the "superregional" Hokkaido Takushoku Bank. It became all too clear that substantial public resources were needed to deal with additional large bank failures, to recapitalize the remaining banks and to bolster confidence in the safety and soundness of the Japanese banking system.

After much political wrangling, ¥60 trillion were made available for the recapitalization and restructuring of the banking system in October 1998. The Long Term Credit Bank and Nippon Credit Bank, two large banks that had survived the summer on Bank of Japan life support, were nationalized in October and December 1998, respectively. The restructuring laws also directed that the HLAC and RCB be merged into something called the Resolution and Collection Corporation (RCC).

THE RCC: FAILING UPWARD

The RCC was established as a joint stock company with the government's Deposit Insurance Corporation as its sole shareholder. It was capitalized at ¥212 billion, but this represented capital already paid into the RCB and HLAC.

The RCC is a family affair, in a very Japanese way. It has a staff of 2,500 – about 2,000 are ex-employees of failed housing loan companies and banks. The remaining 500 employees are temporarily detailed to the RCC by large commercial Japanese financial institutions. As of Aug. 1, 1999, the RCC had 36 "officers," most of whom had close ties to the failed financial system.

The majority of the RCC staff members work on collecting payments on assets received from the various failed institutions. Often the staff of the failed institution is, in effect, assumed by the RCC along with the assets. Indeed, each of the larger failed institutions has an organizational office within the RCC. Thus, there are divisions in the RCC that correspond to each of the seven housing loan corporations that failed in the mid-1990s.

These divisions, manned by the original staffs of the *Jusen* companies, are responsible for the continuing collection on the *Jusen* loans. There are additional business divisions responsible for collection of debts that have

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organized-crime ties, for the purchase of assets from banks that have not failed and for the pursuit of claims or other legal action in the courts and various administrative offices.

THE RESOLUTION AND COLLECTION CORPORATION: THE MANDATE

Bank loans in Japan are generally collateralized by real estate. When loans were transferred onto the books of the HLAC and RCB, they were written down to reflect the decline in the value of the underlying real estate collateral. Generally, this write-down was based on a price index specific to location and type of collateral (for example, Osaka, prime business real estate) minus an additional 15 percent as a cushion.

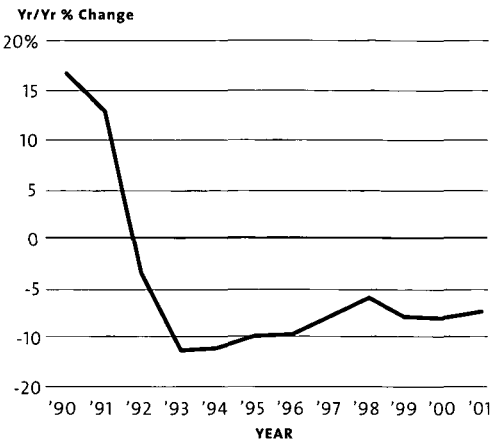
The average write-down on HLAC assets and RCB assets was 55 percent and 78 percent, respectively. The difference in the write-down percentages follows from the fact that RCB assets were added to the books later, after the underlying collateral had further eroded in value. Although the loans were recorded at less than face value, the benefit of this write-down was not usually passed on to the borrower. That is, the borrower was still responsible for the original repayment schedule defined under the original loan agreement. It was hoped that the real estate market would turn around and that collection activities would actually turn a profit. However, prices continued to decline and macroeconomic conditions continued to deteriorate.

RCC officials say the collection process is guided by two main principles:

- Collections will be carried out with "strength," "speediness" and "transparency."
- Collections will at least equal the original purchase price of the assets so as to avoid a future burden on the taxpayer.

Leave aside, for the moment, the highly praiseworthy criteria in the first principle. Look at the second principle, for it embodies much of what is wrong with the Japanese approach to disposing of loans and other assets. There are a number of conceptual problems in attempting to equate a flow (collections) with a stock (the book value of assets). More important, while the purported goal of the RCC collection process – to avoid future costs to taxpayers – seems appropriate, it is unlikely to have that outcome. This approach of maximizing collections ignores costs and makes unwarranted assumptions regarding future asset prices.

CHANGE IN AVERAGE COMMERCIAL LAND PRICE IN JAPAN



HLAC AND RCB COLLECTION: REALITY BITES

The first table below shows the collection performance of the Housing Loan Administration Corporation (HLAC) with regard to the *Jusen* assets. "Collections," in this context, means gross income from loan payments and asset sales. The majority of collections are actual loan payments. By the end of 2000, the HLAC or its successors had collections that equaled more than 50 percent of the value at

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HOUSING LOAN ADMINISTRATION CORPORATION ASSETS

(¥ BILLION)

	ASSETS (PURCHASE PRICE)	COLLECTIONS
FY 1996	4,655.8	275.6
FY 1997		640.5
FY 1998		634.0
FY 1999		430.5
FY 2000		317.2
Apr.–Sept. 2001		128.5
TOTAL	**4,655.8**	**2,426.3**

RESOLUTION AND COLLECTION BANK/RESOLUTION AND COLLECTION CORPORATION ASSETS

(¥ BILLION)

	ASSETS (PURCHASE PRICE)	COLLECTIONS
FY 1996	384.1	34.3
FY 1997	212.5	51.4
FY 1998	1,415.5	261.8
FY 1999*	1,120.8	605.0
FY 2000*	794.7	936.7
Apr.–Sept. 2001*	201.5	415.8
TOTAL	**4,129.1**	**2,305.0**

SOURCE: RCC

*Includes data on assets bought from sound banks (¥34.2 total in FY 1999 and FY 2000), but not HLAC assets shown above.

RCC PURCHASE OF LOANS FROM "HEALTHY" BANKS

(¥ BILLION)

	LOANS (BOOK VALUE)	LOANS (PURCHASE PRICE)	DISCOUNT
FY 1999 1st half	138.4	6.6	95.2%
FY 1999 2nd half	312.6	15.0	95.2%
FY 2000 1st half	150.5	6.3	95.8%
FY 2000 2nd half	371.6	6.3	98.3%
Apr.–Sept. 2001	103.4	5.1	95.1%
TOTAL	**1,076.5**	**39.3**	**96.3%**

which the assets had been transferred to government books. That is, as measured against the second principle of collections above, the *Jusen* problems are almost half resolved.

Recoveries are slowing, however, and officials acknowledge that much of what remains may be uncollectible. Moreover, the HLAC's expenses are relatively high, leaving little for asset write-down. On April 1, 1999, ¥4.1 trillion in *Jusen* assets was transferred to the new RCC. Thus in more than four years, despite collection totaling ¥2.4 trillion, *Jusen* assets under management have declined by only about 10 percent.

In contrast to the *Jusen* account, the RCB has continually added assets from newly failed institutions and direct purchases. Like the HLAC, the RCB was primarily a collections operation – very little was sold outright. The RCC touts a "recovery rate" of 56 percent on these assets. As was the case with *Jusen* assets, however, very little had actually been disposed of. Through the end of the 1998 fiscal year, of ¥6,324 billion in assets held by the RCB and HLAC, only ¥68 billion, or about 1 percent, had been sold outright. Another ¥31 billion had been sold to the government for official use.

RCC COLLECTIONS PERFORMANCE

In April 1999, the HLAC and RCB assets were transferred to the RCC, although collections on the accounts continue to be tracked separately. In addition to receiving assets in connection with bank failures, the RCC may also purchase assets from banks still in business in order to increase their liquidity and keep them in business. Often these assets are tainted by association with *yakuza* (Japanese criminal organizations) and are purchased at huge discounts from the price at which the bank booked the asset. In fact, the daily newspaper *Nihon Keizai Shimbun* reported last October that the RCC had purchased more than half of its loans from operating institutions for one yen each.

The RCC's balance sheet is financed almost entirely from money borrowed through the Deposit Insurance Company. The bulk of the RCC's assets consists of property from the RCB and HLAC (more than ¥8 trillion)

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and convertible and subordinated debt purchased by the Japanese government to shore up banks' balance sheets in 1998 (¥7.5 trillion). In addition, the RCC holds bonds to generate income from the spread between short-term borrowing and the longer-term Japanese government bond rates.

Consistent with the RCC's argument that its mandate is to collect rather than to dispose, the balance sheet has only marginally contracted between the end of the 1999 fiscal year and the end of the 2000 fiscal year. Asset sales were offset by new asset purchases (¥1,916 billion in the 1999 fiscal year and the 2000 fiscal year).

A few items on the RCC's income statement merit special note. First, more than 20 percent of gross income in the 2000 fiscal year was from dividends, presumably from the ¥7.5 trillion holdings of bank capital. Non-interest income includes asset collections and asset sales. The fact that this income almost doubled from the 1999 fiscal year to the 2000 fiscal year suggests that the RCC has increased its efforts to dispose of assets – albeit from a very low base. Finally, loan write-offs and transfers to loan loss reserves absorb sufficient operating income so that net income is close to zero.

RESOLUTION AND COLLECTION CORPORATION BALANCE SHEET

(¥ BILLION)

	FY 2000	FY 1999	PERCENT CHANGE
Cash and liquid securities	2,416.7	1,547.9	56.1%
Securities*	9,788.1	9,929.1	(1.4)%
Loans*	5,184.8	5,801.1	(10.6)%
Bad debt reserve	(563.3)	(373.8)	50.7%
Other	576.5	563.0	2.4%
TOTAL	**17,402.8**	**17,467.3**	

SOURCE: RCC

*Securities includes ¥7.5 trillion in convertible shares and subordinated debt. Loans means assets purchased from banks or received through the bank resolution process.

RESOLUTION AND COLLECTION CORPORATION INCOME STATEMENT

(¥ BILLION)

		FY 2000		FY 1999
Interest and dividend income		204.7		184.9
of which: dividend income	115.8		85.3	
Interest expenses		66.7		59.4
NET INTEREST AND DIVIDEND INCOME		**138.0**		**125.7**
Non-interest non-special income		417.7		226.3
Transfer to loan loss reserve	231.6		147.1	
Write-offs of loans	67.4		83.1	
Operating expense	42.9		42.1	
Others	186.2		118.9	
Non-interest non-special expenses		485.2		349.1
NET INCOME BEFORE TAXES		**3.9**		**2.7**

A RECIPE FOR GRIDLOCK

Thanks to its history, staffing and mandate, the Resolution and Collection Corporation is run like a private bank rather than a public-sector asset disposal organization. Asset disposal would mean that the institution is temporary in nature: when the assets are depleted, the RCC would close up shop as the Resolution Trust Corporation did in the United States in 1995. However, neither the RCC's owner – the Japanese government – nor its staff members wish that to happen.

For its staff the job of collecting income from assets (rather than disposing of them) means job security. For the government, keeping assets on the RCC books and slowly writing them down with collections, dividend and interest income means not having to recognize losses and use taxpayer money. But the capture of the RCC by bureaucrats and politicians with a stake in preserving the status quo constitutes a disaster for Japan as a whole. As long as the banking system remains in gridlock, the prospects for economic recovery will remain poor. And as long as the RCC is in charge, the prospects for breaking the gridlock are equally poor.

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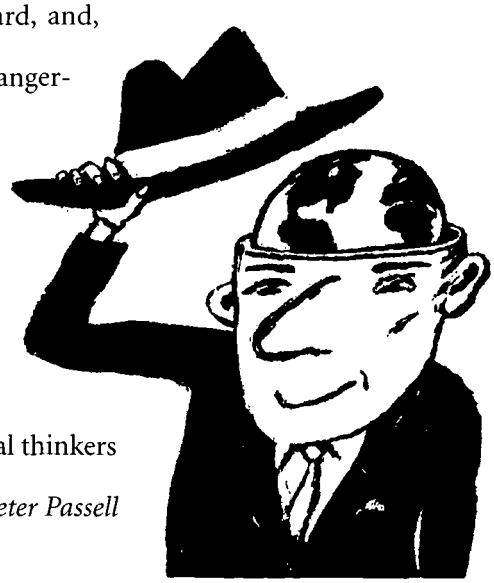
On Globalization

ILLUSTRATIONS BY
JERZY KOLACZ

Once upon a time, Chrysler was an American company, T-shirts were crafted with pride in North Carolina, and foreign aid was not a four-letter word. Sounds great, until you think about it. Who would voluntarily roll back the clock to an era in which most people were poor, American workers sweated away their lives in dirty, dangerous factories, and the only foreign dish in most restaurants was french fries? ¶ Globalization is hard, and, as the events of September 11 proved, sometimes dangerous. But it's a whole lot better than the alternatives. The big question is whether policymakers – and democratic societies – are flexible enough to adjust to a world in which the only certainty is that almost everything will soon be different. Hence my pride in showcasing the ideas of two very original thinkers committed to making globalization work. — *Peter Passell*



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Like a lot of self-made billionaires, Hungarian-born George Soros is a do-gooder on a gigantic scale.

Unlike most, however, his projects are known for both their inventiveness and efficiency – this guy makes things happen. His network of foundations supports initiatives ranging from harm-reduction drug policies in the United States to the construction of low-cost housing in South Africa. Surely, though, his best-known project has been the promotion of civil society in the post-Soviet-transition countries, which includes everything from building universities to defending a free press to preserving the remnants of Gypsy culture in Eastern Europe. ¶ This excerpt from his recent book, *On Globalization,** outlines a typically ambitious – and typically astute – plan for reforming and increasing foreign aid to poor and transitional economies. A bridge too far? Maybe. But prudent folk don't sell short anything that the wizard who brought down the pound sterling is betting on.

— *Peter Passell*

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The missing component of the international financial architecture is an effective method of providing aid that will enable, encourage and reinforce voluntary compliance with international standards on issues ranging from child labor to the protection of international property rights. The arrangements must include not only a source of financing but also an effective method of delivery. The two are interconnected: so little money is available for international assistance today because the results are considered so unsatisfactory. The reputation of foreign aid is worst in the United States. Countries that spend a larger portion of their GNP on aid also have better results to show.

Aid is needed for a great variety of purposes. We may distinguish between two broad categories: providing what economists call public goods on a global scale, and fostering economic, social and political progress in individual countries. The first category includes environmental, educational and health issues. The fight against infectious diseases, for example, cannot be confined to particular countries.

The second category refers, first and foremost, to the promotion of better government. It includes not only an efficient, honest administration and an independent, reliable judiciary, but also the rule of law and an appropriate relationship between the public and private spheres: a society that is not dominated by the state, a private sector that is not in cahoots with the government, and a civil society whose voice is heard. What is appropriate is bound to vary from country to country; Western democracy is not the only possible model. Yet there are some universal principles of liberty and human rights, including freedom of speech and association, and the treatment of minorities and minority opinions, that should be respected. To emphasize that there is no single blueprint appropriate in all cases, I speak of an open society as the objective.

Open society can be taken as a very broad expression of democracy that also includes economic progress and the reduction of poverty. Making the promotion of open society the goal differs from the widely endorsed goal of poverty reduction in that it emphasizes the importance of the political arrangements prevailing in individual countries. The United Nations, being an association of sovereign states, has had to shy away from this issue; but the fact is that poverty and misery are usually associated with bad government. Admittedly, it is difficult to interfere in the internal affairs of sovereign countries, but it is important to face up to the problem.

There are some things that can and should be done by imposing international rules. For example, there is plenty of room for expanding and strengthening international treaties. The Kyoto treaty on global warming (or an improved version of it), the treaty on land mines, and the one on the control of trade in small arms, are highly desirable. The proposed International Criminal Court ought to be brought into existence. But international treaties are hard to agree upon and even more difficult to enforce. The attitude of the United States is currently the major obstacle.

Imposing economic sanctions has limited use and can easily become counterproductive. Trade embargoes are often broken, and those who engage in smuggling are usually allied with the regime the sanctions are supposed to punish. The net effect is to punish the people

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but provide economic sustenance to the regime. That is how sanctions worked in Iraq and Yugoslavia. Unilateral sanctions like those imposed by the United States on Cuba are even less effective. Recently there has been a move toward so-called smart sanctions: travel restrictions and financial measures aimed at people associated with the regime. These hold greater promise.

The most promising approach is to offer positive inducements for voluntary compliance – in short, foreign aid. It may not apply to hard cases like Iraq and the former Yugoslavia, but it would encourage and empower governments that are genuinely interested in improving social conditions. In the case of repressive regimes, foreign aid ought to be confined to nongovernmental channels.

Both the IMF and the World Bank are deeply engaged in providing technical and financial assistance to countries that are ill-prepared to compete in a global economy. These countries comprise what used to be called the second and the third worlds – the formerly communist countries and the less-developed countries – as well as a number of countries that have developed as closed economies and have not yet adjusted to free trade and the free movement of capital. This includes much of Asia and Latin America and practically all of Africa. Together, they constitute the majority of the world's population.

Structural adjustments are needed in many institutions, ranging from the judiciary to health care and education, and in many sectors of the economy, ranging from banking to agriculture and energy. Although the problems vary from country to country, the international financial institutions – IFIs for short – have shown a tendency to apply a common approach. The approach is largely dictated by the nature of the relationship between the IFIs and the recipient countries; most of the assistance has taken the form of loans to governments.

The IMF and the World Bank play somewhat different institutional roles. The World Bank has a large staff and tends to be more hands-on in designing and implementing sectoral loans. The IMF has a smaller staff, focused on macroeconomic issues. It relies on the recipient governments to implement a plan specified in a letter of intent. If a government fails to meet the specified conditions, the IMF stops disbursing funds.

Because the IFIs control the funds, they act as the arbiters of the kind of economic reforms they will support and on what conditions. They have developed a more or less standardized approach to economic reform: the IMF has one prevailing doctrine, while the World Bank offers a standard menu from which the recipients can choose.

This approach has produced very mixed results. For instance, a World Bank evaluation of 10 African programs published just last year lists two successes, two outright failures, and the rest somewhere in between. Evaluations from other parts of the world are not very different.

The most ambitious undertaking entrusted to the IFIs – assisting the countries of the former Soviet empire in making the transition to a market economy – has fallen far short of expectations. Some of the former satellites have muddled through, but Russia has only recently begun to show signs of economic recovery with market reforms taking hold.

In my view, the task should never have been entrusted to the IFIs. The IMF makes borrowing governments sign letters of intent and suspends disbursements if the borrowers fail to meet the conditions. When governments break down, as happened in most of the formerly communist countries, they are not in a position to carry out their intent. A

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different, more intrusive approach was needed, and at that time it would have been welcomed by the Soviet Union and the successor states. The right policy would have been for the West to come to their aid, as the United States did in postwar Europe with the Marshall Plan. But the idea was not even considered. When I proposed it at an East-West conference in Potsdam in 1989, I was laughed at by the audience, led by the deputy foreign secretary of the Thatcher government. The Western democracies did not want to take the responsibility; nor did they want to foot the bill out of their own budgets. That is why they assigned the task to the IMF and the World Bank.

When the IMF got the assignment in 1992, I suggested that it should use a more purposeful and intrusive way of delivering its support. I proposed that a $10 billion IMF program for Russia be earmarked for the payment of pensions and unemployment benefits, and that its disbursement be organized and supervised by the IMF. The same money that was given to the government for balance-of-payments and budgetary support could have also been used to provide a social safety net. But instead of disappearing in government coffers, the money would have been broadly distributed and people in Russia would have seen visible evidence of international assistance. The plan would have encouraged the restructuring of industry by generating consumer demand, and it would have provided some measure of social protection for those who were displaced by such restructuring.

Since the plan was not even considered, I set out to demonstrate that it was feasible. I established the International Science Foundation with $100 million and distributed less than $20 million to some 35,000 leading scientists in the former Soviet Union, according to very transparent criteria of excellence. The scientists received $500 each on which they could live for a year. (The Russian exchange rate was deeply depressed.) It was perhaps the only case in which people received help in a tangible form, and they – and society at large – have never forgotten it.

This demonstrated on a small scale what could have been done on a larger scale. Imagine if all the pensioners had received their pensions and the unemployed had been given unemployment benefits. I am convinced that history would have taken a different course. Consider the difference that the Marshall Plan made in postwar Europe, not only in fostering economic reconstruction but also in generating lasting ties of goodwill. As it is, a historic opportunity was lost. Standards of living in the former Soviet Union dropped precipitously – according to World Bank data both absolute and relative poverty increased sharply in the transition countries – and a rapacious and violent business culture took hold.

The international community has not done much better in the Balkans. Billions were spent in Bosnia, with very little to show for it. There was inadequate coordination among donors, and most of the aid went through governmental channels. I proposed setting up a fund in conjunction with the World Bank to finance projects directly, but the Bosnian government insisted on control. With so many donors competing to pass through the same gates, the gatekeepers could divert the funds to their own purposes.

There are lessons to be learned from these failures. The shortcomings of international assistance have been extensively studied, and a new paradigm is emerging. It is recognized that the countries themselves must take charge of their development programs, and governments must consult with their citizens in preparing them. The World Bank pioneered the Comprehensive Development Frame-

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works (CDF), and the IMF, together with the Bank, requires a Poverty Reduction Strategy Paper (PRSP) in connection with concessional loans and debt forgiveness for Highly Indebted Poor Countries (HIPC) — I use the official acronyms to suggest the bureaucratic nature of the enterprise. These initiatives are in their infancy, but they show promise and deserve to be encouraged.

Although I am in sympathy with the emerging paradigm, I believe there are other lessons to be learned. One of them is that the IFIs are ill-suited to deal with the problem of bad government. They are obliged by their charters to go through governmental channels. This makes them bureaucratic, and bureaucrats are averse to risk. One of the advantages of letters of intent is that the IMF cannot be blamed if the intent is not carried out. Going outside governmental channels entails a much higher level of responsibility. Bureaucracies are justified in avoiding or deflecting risk; they can be second-guessed by a whole range of kibitzers. International bureaucracies are particularly vulnerable because they have to serve a multitude of masters. Both the U.S. Congress and the European Parliament have shown a tendency to micromanage foreign aid. In recent years, Congress has extended micromanagement to the activities of multilateral institutions, including the United Nations and the IFIs.

Systemic reform is a high-risk enterprise. The risks are even greater than in private enterprise, and there is no single bottom line by which success can be judged. Social change is a nonlinear, reflexive process. The right policy at one moment may no longer be appropriate at the next. This means that the outcome cannot be predicted in advance. Systemic reform is a hit-or-miss affair, as uncertain as the behavior of financial markets.

The IFIs have an important role. They can play it best when they deal with a reform-minded government that they can assist. The new paradigm may help the IFIs to perform better. But there is a pressing need to go beyond governmental channels. There are certain functions that only governments can fulfill, and one of the best uses of foreign aid is to increase the capacity of governments. But governments are not the most efficient economic agents; there is something wrong with international assistance if it serves to increase the role that governments play in the economy.

When the Soviet system collapsed, the West failed to provide adequate support to governments to fill the role they have to play in a market economy – and instead of a transition there was a collapse. We discovered the hard way that the collapse of a closed society does not automatically lead to the creation of an open society, and that a nonfunctioning state can be as much of a threat to liberty and prosperity as a repressive one.

By the same token, international assistance given to repressive or corrupt regimes can serve to reinforce those regimes. Indeed, in some cases, foreign aid becomes the main source of support for those regimes. That is apt to happen when the aid is guided by geopolitical considerations. It happened often during the Cold War, and is likely to happen again as the United States fights terrorism.

The use of nongovernmental channels becomes particularly important in the absence of a reform-minded government. International assistance can then foster an open society by providing a precious counterweight to a domineering and inefficient government. But support of the private sector and civil society is also essential where there is a reform-minded government. A democratic government should encourage the use of nongovernmental channels.

International assistance is thus a compli-

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International assistance given to repressive or corrupt regimes can serve to reinforce those regimes. Indeed, in some cases, foreign aid becomes the main source of support for those regimes

cated business. There is no single formula to fit all cases. Instead of a bureaucratic approach, we should take an entrepreneurial one. But social entrepreneurship is even more difficult than making money, as I have learned from personal experience. In making money there is a simple criterion of success: the bottom line. All the various items that enter into the account serve a single goal – profit. In serving the public good, the situation is reversed. Instead of a single line, the social consequences of an undertaking show up in a variety of lines, and the various lines cannot be readily aggregated. The GDP is often used as a proxy, but that can be very misleading, because different people are affected differently and there are many unintended consequences to economic growth. Judged by the standards applied in business, international assistance is bound to be inefficient. One of the reasons foreign aid has such a bad reputation in the United States is that it is judged by the wrong standard.

Social entrepreneurship ought to play a larger role in international assistance. It should not replace intergovernmental programs, but supplement them. There are many successful social initiatives. But the amounts available for international assistance are far from sufficient and have been falling since

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SDRs: The Nuts and Bolts

The International Monetary Fund has the authority under the Articles of Agreement to issue Special Drawing Rights (SDRs), which are international reserve assets that serve as units of account and as a means of payment among fund members, the Fund itself and other holders, who must be approved by the IMF executive board by an 85 percent majority. The SDRs constitute part of a country's official foreign-exchange reserves. A number of international agencies and development banks use SDRs as units of account. Members and prescribed holders may buy and sell SDRs for foreign exchange; borrow, lend or pledge SDRs; use SDRs in swaps and forward operations; use them in settlement of financial obligations; and use or receive SDRs in donations.

The value of the SDR is determined by a basket of four major currencies: the United States dollar, the euro, the yen and the pound sterling. On Jan. 1, 2002 one SDR was worth $1.26. IMF members can use SDRs to purchase currencies from other members at the current exchange rate, which is adjusted daily. The IMF will help "other holders" of SDRs to arrange purchases of currencies.

An SDR is an interest-bearing asset. Members receive the SDR interest rate on their holdings, and pay the SDR interest rate on their allocations. The SDR interest rate (paid by members drawing down their original allocations to purchase currencies from other members, and earned by members whose SDR holdings increase as a result of these transactions)

1990. In November 2001, the British Chancellor of the Exchequer, Gordon Brown, called for $50 billion in additional foreign aid annually from the rich countries of the world, but his proposal did not appear to get serious consideration at the subsequent meeting of the IFIs in Ottawa. To mobilize additional resources, the public must be convinced that the money will be well spent. That requires explaining the difficulties inherent in foreign aid and finding better ways to administer it.

THE TOBIN TAX

Several innovative sources of financing for foreign aid have been suggested, but none will be adopted unless public opinion demands it. One of the more popular proposals, put forth by the recently deceased Nobel Prize-winning economist James Tobin, called for a tax on currency-exchange transactions. There is a case to be made for such a tax, but it is somewhat different from the argument put forward by Professor Tobin. It is not at all clear that a Tobin Tax would reduce volatility in currency markets – its stated purpose.

A Tobin Tax would indeed discourage currency speculation, but it would also reduce the liquidity of the marketplace so that "chunky" transactions, such as the acquisition of large companies, would have a greater impact on exchange rates. This could be counterbalanced by the more frequent use of official reserves. For example, currency for large corporate transactions could be provided from government reserves. But that would involve a substantial change in how currency markets are managed, and there is no evidence that the authorities would be willing to take on the additional responsibility.

The case for a Tobin-type tax is different.

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is based on a weighted average of representative short-term debt of the countries whose currencies constitute the SDR basket (France, Germany, Britain, the United States) and is adjusted weekly. On Jan. 1, 2002 the interest rate was 2.32 percent.

SDRs are created through a process of allocation and distribution to IMF members. The most recent SDR allocation was made in 1981, bringing cumulative allocations to 21.4 billion SDRs. SDRs must be approved by an 85 percent supermajority of total voting power in the IMF, and are distributed to individual member countries according to quota share. The IMF can cancel SDRs, but has never done so.

In 1997, the IMF members agreed to amend the IMF Articles to allow a special allocation of SDRs that would channel a bigger share to the former Soviet republics and other transition countries (as well as poorer countries) than would result from the standard quota-based distribution.

An amendment to the Articles also requires an 85 percent majority for ratification. As of December 2001 members representing 72.7 percent of the vote had ratified the fourth amendment. Ratification by the United States, which has 17.13 percent of the total vote, is necessary to put it over the top. This would require approval of the U.S. Congress.

Ratification of the amendment would trigger an immediate allocation of 21.433 billion SDRs, doubling the total outstanding and significantly boosting the foreign-exchange reserves of transition and poorer countries – although the wealthier members would still get two-thirds of the total allocation under the modified formula.

The globalization of financial markets has given financial capital an unfair advantage over other sources of taxation; a tax on financial transactions would redress the balance. Why should there be a value-added tax on physical transactions, but no tax on financial transactions?

On these grounds the tax ought to be extended to all financial markets, not only currency markets. There are serious problems of implementation, but they could be resolved. How could financial derivatives and other synthetic instruments be taxed? This looks like a thorny problem, but in fact it is easily solved. There is a measure called delta that shows the equivalent of a derivative in terms of the underlying security. The tax could be levied on the delta of derivatives at the time of the transaction.

The problems connected with the collection of the tax are more serious. Collection has to be worldwide, including tax havens. How could it be enforced? The collecting country has to be given a share of the proceeds. How big a share should that be? All these problems could serve as an excuse for not introducing a financial-transaction tax. Even if they were overcome, the question of how to spend the money effectively would remain.

As antiglobalization protests have demonstrated, it is easier to organize people against something than for something. To mobilize public opinion in favor of increased international assistance, the proposal must show not only how the money will be raised but also how it will be spent.

THE SDR PROPOSAL

I have such a proposal. It involves the issuance

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of special drawing rights (SDRs) that rich countries would donate for the purpose of providing international assistance. This could make a substantial amount of money available almost immediately to finance the provision of public goods on a global scale as well as to foster economic, social and political progress in individual countries. Indeed, it could point the way to a large, continuous and predictable flow of financing for development indefinitely.

SDRs are international reserve assets issued by the IMF to its members and convertible into other currencies. Less-developed countries would add their SDRs to their monetary reserves; richer countries would donate their allocations according to certain rules. Less-developed countries would benefit both directly through the addition to their monetary reserves and indirectly from the provision of public goods on a global scale.

There is widespread agreement that the amount of money available for international assistance has to be significantly increased. The Zedillo report, prepared for the Monterrey Conference on Financing Development (download from www.un.org/esa/ffd/a55-1000) estimates that meeting the UN's 2015 development targets may require an extra $50 billion per year, and that seriously addressing the need for public goods would require another $20 billion.

The proposal to use SDRs for international assistance would be implemented in two stages. In the first stage, a special 21.43 billion SDR issue (equal to approximately $27 billion) already authorized by the IMF in 1997 and currently awaiting ratification by the United States Congress, would be approved by Congress with the proviso that the richer countries donate their allocations. Since the richer countries would get most of the SDR allocation even under the amended formula of the 1997 decision, nearly $18 billion from 38 countries could be made available immediately for international assistance.

This would be a practical test of the idea. If successful, the initial issue would be followed by regular annual allocations of SDRs, and the amounts could be scaled up. Clearly, the plan proposed here could go a long way toward meeting generally agreed development targets.

Using SDRs would not only increase the total amount available for international assistance, but also ensure that all developed countries contributed equitably because the quota-based distributions of SDR allocations are roughly proportional to the economic strength of member countries. Any common effort suffers from the so-called free-rider problem: The community as a whole is better off if the effort succeeds, but each member of the community is better off by not contributing. Use of the SDR mechanism cures the free-rider problem.

Most important, the plan proposed here would correct many of the shortcomings of foreign aid, especially as it is currently administered by governmental aid agencies. These advantages ought to be preserved, whether or not the SDR mechanism is adopted to raise funding.

As noted above, the contribution of individual countries to international assistance is highly uneven; the United States is the laggard, with only one-tenth of 1 percent of its GDP devoted to foreign aid. The proposed special issue amounts to roughly one-tenth of 1 percent of the global GDP, and the size of subsequent issues could be scaled up. Since the SDR donations are designed to supplement the current level of foreign aid, their use should ensure a greater volume of international assistance and a more equitable distribution of the cost. Even more important is

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the mechanism that would be used to distribute the aid. A new approach to financing would be accompanied by a new approach to managing international assistance. I propose creating a kind of market in which programs compete for donors' funds. This is how it would work.

An international board operating under the aegis of the IMF but independent of it would be set up to decide which programs are eligible for SDR donations. The board's members would be eminent people appointed for fixed terms, and not under direct instruction from their governments. A separate audit commission would arrange for independent monitoring and evaluation. The board would propose a strategy in its annual report, but it would have no authority over the spending of funds. It would merely prepare a menu from which the donors would be free to choose, creating a marketlike interplay between donors and programs, supply and demand. The quality of the programs would be ensured by the board, and the quality of the donors' choices would be open to public scrutiny.

Some may not appreciate the importance of creating an international board consisting of eminent people selected on the basis of publicly stated professional qualifications, and not the usual government appointees. In the case of the UN-sponsored trust fund to fight HIV/AIDS, tuberculosis and malaria currently in formation, all the major donors want to be represented on the board, and it is only with difficulty that the size of the board has been whittled down to 18; seven of the board seats are still reserved for the G-7 countries. The Secretary General of the UN is not in a good position to exert pressure on member countries because he is their servant; a board of eminent people would be much better situated.

The menu would include trust funds for the provision of public goods on a global scale, as well as matching funds for a variety of social initiatives. For the first SDR issue the list of eligible programs would be confined to three or four specific priority areas, like public health, education, information technology (the digital divide), and judicial reform. I would include judicial reform because IFIs are not allowed to pay supplemental salaries to government employees, and that is often the key stumbling block to judicial reform. For example, Georgia, one of the most corrupt countries in the world, appointed qualified judges selected by competitive examination, but was unable to deliver on the promise of decent salaries. Programs under this aid plan would not be subject to the same constraint.

Using SDRs would not only increase the total amount available for international assistance, but also ensure that all developed countries contributed equitably.

Government-sponsored poverty-reduction programs would be excluded; they would be left to the IFIs. This would help to make the test more successful. Specific program areas could be dealt with by sub-boards whose members would have the necessary professional qualifications. There would be also a better delineation of responsibilities

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and less room for institutional rivalry. In the case of public health, the board of the newly formed trust fund to fight infectious diseases could act as the sub-board, provided the donors agreed to the selection process proposed here.

If the implementation of the first SDR issue were successful and SDRs were issued annually, the range of eligible programs would be expanded. Government-sponsored poverty-reduction programs could also qualify, but only up to a certain limit, in order to leave funds for nongovernmental channels. By that time, the new paradigm currently being formulated by the IFIs will have been elaborated. Some limits, however, would have to be placed on the amount of SDRs that could be committed to government programs; otherwise, those programs are liable to absorb all the available funds. Governments prefer intergovernmental channels. It is important that other initiatives not be starved of funds because, as I stressed previously, there is no single formula to fit all cases. I shall give some practical examples of the kind of programs that ought to qualify for support.

My own foundation got involved in a program for treating tuberculosis in Russian prisons in 1997. Our goal was to improve prison conditions, and we sought to gain the cooperation of the prison authorities by treating a disease that affected prisoners and prison guards alike. We applied an up-to-date method of treatment recommended by the World Health Organization called DOTS – directly observed treatment–short course – thinking that with a $15 million grant we could make a major impact. We soon discovered that an overwhelming number of prisoners were infected with multi-drug-resistant strains of tuberculosis (MDR-TB) that was impervious to DOTS treatment. Sticking to the plan could have actually increased the incidence of MDR-TB, which constitutes a costly global threat. An epidemic in the jail on Rikers Island and other parts of New York City in the early 1990s cost approximately $1 billion to control. Obviously, we had run into a problem in Russia that far exceeded our financial capacity, as curing MDR-TB at that time would have cost $15,000 per patient.

We mobilized the best experts in the field and commissioned Partners in Health in Boston to prepare a study on the global impact of MDR-TB. One of the outcomes was the reduction of the cost of treating MDR-TB to as little as $300 per patient. As a next step, we asked Partners in Health to develop a business plan for dealing with TB on a global scale. Together with STOP-TB – a partnership of 190 collaborating organizations including the World Health Organization, the World Bank, governments of the 22 most directly affected countries, and representatives of the nongovernmental organization community and private sector – they produced a "Global Plan to Stop TB."

The plan was unveiled at the World Bank in Washington in October 2001. It calls for spending $9.3 billion over five years: $4.8 billion would come from the budgets of the affected and donor countries, leaving a financing gap of $4.5 billion. That gap could be filled by the donation of SDRs. The "Global Plan to Stop TB" could also be helpful in pointing the way for the newly formed UN-sponsored Global Fund to Fight AIDS, TB and Malaria.

As regards creating a marketlike interaction between donors and programs, my foundation network has participated in preparing a Global Exchange for Social Investment, which was introduced at the World Economic Forum meeting in February 2002. Bain & Company has acted as principal consultant

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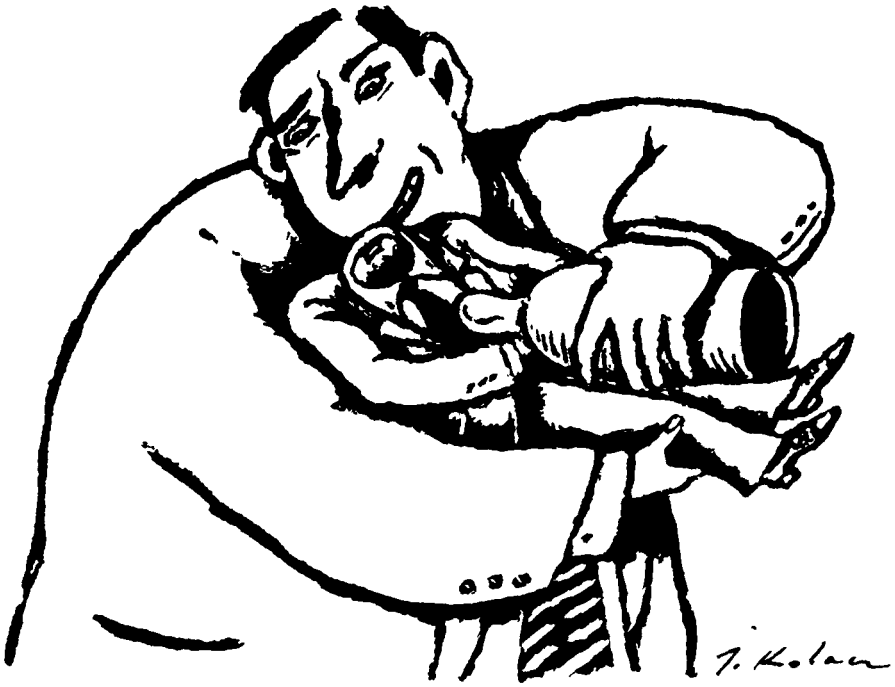

on a pro bono basis. It has developed a certification process to designate authorized intermediaries who, in turn, submit a list of projects for which they are willing to take moral or administrative responsibility. Corporate donors, foundations and philanthropically minded individuals are invited to go shopping from the list. This is a practical private-sector test of the SDR donation plan. If successful, the Global Exchange for Social Investment could be included in the list that qualifies for matching funds from SDR donations.

Microlending – very small loans to very small businesses – would constitute an important element in social entrepreneurship. There is ample evidence that it can work. The difficulty is in scaling it up. Successful microlending operations are largely self-sustaining, but they cannot grow out of retained earnings or raise capital in the financial markets. To turn microlending into a significant factor in economic and political progress, ways have to be found to attract additional capital. This would require general support for the industry as well as capital for individual ventures. Industry support would include developing management software and making it available at no charge, training managers, and establishing a rating agency and a loan-guarantee plan. The rating agency would help to attract philanthropically minded equity investors who would be willing to accept below-market returns or no return at all; the loan-guarantee plan would enable qualified microlending institutions to issue commercial paper. The World Bank's callable capital could also be used for guarantees, giving the paper a AAA rating.

Another important element would be stipends for educational purposes along the lines developed by Bolsa-Escola, the Brazilian plan that pays subsidies to poor families provided their children attend school regularly. Combining education stipends with health care and microlending could move large segments of the population out of poverty.

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The SDR donation mechanism could be particularly useful in connection with regional or national donor conferences. The Balkans provide an excellent example. There was general agreement on the need for a coordinated regional approach in the wake of the collapse of Yugoslavia. This led to the establishment of the Stability Pact for South Eastern Europe, but the pact remained an empty shell because the donors retained control of the amounts pledged and followed their own agendas. If the stability pact had been designated as a potential recipient of SDR donations, the projects approved by the so-called working tables of the pact might have received adequate funding, and international assistance could have been more successful.

Afghanistan is another case in point. If donor countries retain control over the spending of their aid, failure is almost guaranteed. A more coordinated approach is needed. Aid should be delivered at the community level, and instead of a large number of aid agencies running around in an uncoordinated manner, a lead agency has to be put in charge. In this case the United Nations Development Program is well situated. Together with other UN agencies, it has had several thousand Afghan employees on the ground during the current conflict, and their numbers could be increased rapidly by recruiting among the Afghani diaspora. Giving control of the purse strings to an international agency like the UNDP could avoid repeating the mistakes of the past. Local warlords could stick to their territories instead of fighting for control of Kabul, as they have done previously.

Of course, UNDP personnel in charge of money would have to be protected by a UN peacekeeping force, but the newly formed government could not object because that is the only way that recovery aid would be made available. After a period of consolidation, the UNDP would withdraw and a newly elected government would take over the local infrastructure that has been established.

Admittedly, all this could be done without SDRs. But the SDR plan, if it were available, would facilitate the pooling and joint management of donor resources.

There is a strong case to be made for annual SDR allocations quite apart from the donation plan. As a consequence of globalization, international trade has been growing at roughly double the rate of global GDP. To avoid balance-of-payments disruptions, countries must maintain a prudent ratio of reserves to imports. Typically, reserves equal to three months' imports are regarded as the absolute minimum. It follows that poor countries have to set aside part of their export earnings to build up their reserves. The SDR allocations would ease this burden, which has become heavier since the crisis of 1997–1999 reversed the flow of capital from emerging markets.

The developed countries have no use for SDR allocations. Their monetary reserves are adequate – in the case of Euro-zone countries even redundant, since the combined reserves of the European Central Bank and national central banks totaled an astonishing 393 billion euros in the fall of 2001 – and if they ran a payment deficit they could always borrow. That is why it has been so difficult to forge a consensus in favor of issuing SDRs. But if the developed countries found a use for SDRs by donating them, the political case for issuing SDRs would be greatly strengthened.

Central banks have been traditionally opposed to SDR allocations because they infringe on their monopoly over the money supply. Their mantra has been that SDRs are inflationary. But the prospects for inflation in the near term are low. Indeed, there is a pos-

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sibility that the steady decline in the cost of imported goods could lead to global deflation. As the case of Japan shows, there are no readily available remedies for deflation. An annual issue of SDRs, the bulk of which is actually spent on international assistance, could turn out to be a useful monetary tool.

LEGAL CONSIDERATIONS

The regular issuance of SDRs is already provided for in the IMF's Articles of Agreement. The rules also specifically stipulate that SDRs may be donated. Linking SDRs and aid has been discussed off and on, including during the 1980s debt crisis. In 1986 the Interim Committee, the IMF's ministerial advisory body, rejected such a link: "The Committee stressed the monetary character of the SDR, which should not be a means of transferring resources, and recommended that the Executive Board study possible improvements in the monetary character of the SDR that would increase its attraction and usefulness as a component of monetary reserves."

But the 1997 IMF decision for a one-time allocation with a special distribution formula that would result in transition and emerging-market countries getting a bigger share broke with the principle affirmed in 1986. The clear intent of this decision was to transfer resources – in this case, monetary reserves.

In the most recent discussion of the subject, the IMF reaffirmed that under its Articles, "SDRs can be allocated only on the basis of a finding of long-term global need or, upon adoption of the fourth amendment," which would double the number of SDRs and bolster the foreign-exchange reserves of poor countries and those in transition. In response to my proposal it was acknowledged that "there is nothing to prevent countries from voluntarily agreeing to transfer SDRs to other countries or prescribed holders for reasons of their own choosing. . . ." The mechanics of the Soros proposal are similar to earlier proposals involving a post-allocation redistribution of SDRs through quasi-independent trust funds." Since there is a long-term need to supplement reserves by issuing SDRs quite independent of the donation plan, my proposal clearly meets legal requirements. The donation plan simply makes the case for issuing SDRs stronger. Whether to use SDRs for international assistance is therefore clearly a political decision. I believe the time is ripe for it.

Whether SDR donations should be treated as a budget item is a vexing question. A case can be made on both sides. In principle, the allocation of SDRs is a bookkeeping item, but when the SDRs are donated, that is a real expenditure. This is the case for including it in the budget. But the allocation of SDRs goes to strengthen the monetary reserves – in the case of the United States, the Exchange Stabilization Fund. If an equivalent amount is then withdrawn and spent, the monetary reserves remain unaffected except for the interest obligations vis-à-vis the fund.

Central banks, or in the United States' case, the Treasury, do not normally seek appropriations to cover changes in their foreign exchange reserves, including interest earned or lost. That is the case for making the donations outside the budget. Putting SDR donations through the budget process could create difficulties, particularly in EU countries that are up against the limits imposed by the Maastricht Treaty and the Stability Pact that underpin the European Monetary Union. Avoiding the budget process altogether would run into the strenuous opposition of the monetary authorities, and rightly so, because it would be a breach of budget discipline.

Under its Articles, the IMF may cancel as well as create SDRs. It could be argued that donations of SDRs should be put through the

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budget process only when the SDRs are recalled, because it is only then that the donation has an impact on the balance sheet of the central bank – or in the case of the United States, on the Exchange Stabilization Fund. In the end, it is up to each country to decide how to treat its SDR donations. The United States may decide to include it in the budget at the time the donation is made or not to include it at all; EU countries may use their excess monetary reserves for the purpose.

MERITS OF THE PROPOSAL

The SDR proposal would help poor countries in two ways – indirectly through the donations and directly through an addition to their monetary reserves. The addition is interest-free, because, as long as they hold on to their SDR allocations, the interest income and expenditure cancel out. That is as close to a free lunch as possible – it remains free as long as you don't eat it. To mix metaphors, the SDR plan kills two birds with one stone – which makes it more efficient but also more difficult to explain.

SDR donations would be in addition to, and not a replacement for, bilateral aid. The donations would be voluntarily deposited in an escrow account, and if they are not allocated, the interest would accumulate in that account and not accrue to the benefit of the donor country. This would ensure that the donations are actually spent. The plan proposed here would prevent donor countries from using their SDR allocations to finance their bilateral aid programs.

There is widespread opposition, particularly in the United States, to the creation of new international institutions. Such institutions are perceived as bureaucratic and wasteful – and not without justification. Part of what makes them top-heavy and expensive to operate is that the member countries insist on exercising control and on using the institutions for patronage. The plan I am proposing would avoid that drawback. It would amount to a new international institution, but it would be radically different in character from the existing ones. The board would operate under the aegis of the IMF for legal reasons, but would in fact be independent.

It could be an extremely low-overhead operation. The plan would function more like an organized market: There would be public interaction between donors and programs reminiscent of the interaction between supply and demand. Both the performance of the programs and the allotment of SDRs would be open to public scrutiny. It may seem paradoxical that I should be advocating a kind of market in foreign aid after I had inveighed against the dangers of market fundamentalism, but I have never denied the merits of markets as a feedback mechanism.

For a foreign aid market to be successful, it is important to realize that it is bound to be less efficient than a normal market. As mentioned previously, there is no single criterion of success similar to the bottom line in business. There are some objectives that can be measured by quantitative indicators like mortality or literacy, but it would be limiting and distorting to confine the objectives to ones that have quantitative indicators.

Success is harder to achieve in a social enterprise than in business, and it is even harder to measure. Once the point is accepted, failures will be better tolerated and successes more appreciated. That would make social entrepreneurship easier to practice and would attract more talent.

I identified five factors that render international assistance ineffectual. I believe the plan I am proposing would mitigate those shortcomings.

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• **The ability of donors to use foreign aid to satisfy their own needs would be greatly reduced.** Perceived national interests would of course continue to weigh heavily on the selection of projects, but there is nothing wrong with that.

• **A marketplace of projects would give both the donors and the project managers a sense of ownership and responsibility.**

• **The stranglehold of intergovernmental dealings would be decisively broken.** The great advantage of trust funds is that they need not be channeled through governments. Governments could no longer act as gatekeepers, and oppressive and corrupt regimes would no longer have a license to misappropriate resources. Instead of many donors competing to go through a single entry point – namely, the recipient government – there would be many projects competing for donor support. The gatekeeper problem would be resolved, at least in theory.

• **Donor coordination would be enhanced because programs would have to be approved by a board to qualify for SDR donations.** With each country contributing according to its quota, the free-rider problem would be eliminated.

• **The risks inherent in foreign aid would be better recognized and projects structured more like venture capital than like a bureaucratic exercise.** Even with the best will in the world, success is bound to vary considerably depending on timing, specific structural details, or sheer luck. A marketplace of projects cannot ensure the optimum allocation of resources, but it can take advantage of the main merit of markets by providing rapid, reliable feedback.

My optimistic expectations are based on real-life experience. The principles I have outlined here have been put into practice in my foundation network – although they were never spelled out so explicitly. The foundations have, in effect, functioned as trust funds, receiving their allotments from an international board.

The results have largely conformed to the expectations stated here: some have been great, others less so, but the positives outweigh the negatives and the negatives are rapidly identified and abandoned. Overall, I strongly believe the results are positive enough to justify applying the approach on a larger scale. Admittedly, a public enterprise cannot duplicate a private one, but it can benefit from its example.

The SDR proposal could be implemented at the next meeting of the IMF. It would not displace the other sources of financing discussed in the Zedillo report. Those should also be considered, but I believe this proposal is superior in many respects. There are no problems of tax collection, the legal groundwork is already laid, and the plan could be tested by a one-time allocation that only needs the approval of the United States Congress to become effective.

Its main drawback is that it is complicated and difficult to understand. It serves more than one objective, and expert opinion on the use of SDRs as a monetary tool is bound to be divided.

But where there is political will for more and better international assistance, there is a way to overcome all possible objections. In the post-September 11 atmosphere, it should be possible to muster the political will.

The SDR donation plan would not cure all of globalization's ills. Nor would the mechanism I have proposed for spending the SDRs avoid all the pitfalls of international assistance. It would, however, offer a better chance of making it more effective. That is all that one can expect in an imperfect society that holds itself open to improvement. M

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What does Joe Stiglitz's Nobel-Prize-winning research have to do with this indictment of the IMF and its banker friends?

No doubt, Stiglitz could come up with something in a flash – he's as quick on his feet as he is passionate about political economy. But this excerpt from *Globalization and its Discontents** stands on its own. ¶ One interesting sub-theme worth noting in Stiglitz's brief career as a policymaker is his role as critic from within the economics establishment. I would put him on a short list of gadflies (along with Jeff Sachs, also of Columbia University) who have resisted the profession's drift to the right on issues of development and international finance. ¶ Is this attack of the multilateral lenders' role in the Asian financial crisis on target? The jury is out. But I'd certainly rather read Stiglitz on the subject than parochial critics of globalization who want to roll back the clock to 1956. – *Peter Passell*

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When the Thai baht collapsed on July 2, 1997, no one knew it was the beginning of the greatest economic crisis since the Great Depression – one that would spread from Asia to Russia and Latin America, and threaten the entire world. For 10 years, the baht had traded at around 25 to the dollar; then overnight it fell by 25 percent. Currency speculation spread and hit Malaysia, South Korea, the Philippines and Indonesia, and by the end of the year what had started as an exchange-rate disaster threatened to take down many of the region's banks, stock markets and even entire economies.

The crisis is over now, but countries like Indonesia will feel its effects for years. Unfortunately, the policies imposed by the International Monetary Fund during this tumultuous time worsened the situation. Since the IMF was founded precisely to avert and deal with crises of this kind, the fact that it failed in so many ways has led to a major rethinking of its role, with many calling for an overhaul of the IMF's policies and the institution itself.

Indeed, in retrospect, it became clear that the IMF not only exacerbated the downturns but also was partially responsible for their onset. Excessively rapid financial- and capital-market liberalization was probably the single most important cause of the crisis, though mistaken policies on the part of the countries themselves played a role as well. Today, the IMF acknowledges many, but not all, of its mistakes. Its officials realize how dangerous, for instance, excessively rapid capital-market liberalization can be. However, the admission comes too late to help the countries afflicted.

Over the preceding three decades, East Asia had not only grown faster and done better at reducing poverty than any other region of the world, but it had been spared the ups and downs that mark all market economies. Indeed, so confident had the IMF been about the region that it reportedly assigned a loyal staff member as director for the region as an easy preretirement posting.

When the crisis broke out, I was surprised at how strongly the IMF and the United States Treasury criticized the countries. According to the IMF, the Asian nations' institutions were rotten, their governments corrupt, and wholesale reform was needed. How, I wondered, if these countries' institutions were so rotten, had they done so well for so long? The difference in perspectives between what I knew about the region and what the IMF and the Treasury alleged made little sense until I recalled the debate that had raged over the East Asia miracle itself.

The IMF and the World Bank had almost consciously avoided studying the region – though it would have seemed natural for them to turn to it for lessons for others. It was only under pressure from the Japanese that the World Bank had undertaken the study of economic growth in East Asia, and then only after the Japanese had offered to pay for it. The reason was obvious: the countries had been successful not only in spite of the fact that they had not followed the dictates of the so-called Washington consensus, but also because they had not. Though the experts' findings were toned down in the final report, the World Bank's Asian Miracle study laid out the important roles that government had played. These were far from the minimalist roles beloved of the Washington consensus.

There were those, not just in the international financial institutions but in academia,

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who asked, was there really a miracle? "All" that East Asia had done was to save heavily and invest well! But this view misses the point. No other set of countries around the world had managed to save at such rates and invest the funds well. Government played an important role in enabling East Asia to accomplish both things simultaneously.

When the crisis broke out, it was almost as if many of the region's critics were glad; their perspective had been vindicated. While they were loath to credit the region's governments with any of the successes of the previous quarter century, they were quick to blame the governments for the failings.

Whether one calls it a miracle or not is beside the point: the increases in incomes and the reductions in poverty in East Asia over the last three decades have been unprecedented. No one visiting these countries can fail to marvel at the developmental transformation – the changes not only in the economy but also in society. Thirty years ago, thousands of backbreaking rickshaws were pulled for a pittance; today, they are only a photo opportunity for the camera-snapping tourists flocking to the region.

The combination of high savings rates, government investment in education and state-directed industrial policy all served to make the region an economic powerhouse. Growth rates were phenomenal for decades and the standard of living rose enormously for tens of millions of people. The benefits of growth were shared widely. There were problems in the way the Asian economies developed. But overall, the governments had devised a strategy that worked, a strategy that had but one item in common with the Washington consensus' policies: the importance of macro stability.

As in the Washington consensus, trade was important, but the emphasis was on promoting exports, not removing impediments to imports. While the Washington Consensus' policies emphasized rapid financial and capital market liberalization, the East Asian countries liberalized only gradually. Some of the most successful, like China, still have a long way to go.

In the Washington Consensus' view, industrial policies in which governments try to shape the future direction of the economy are a mistake. But the East Asian governments took that as one of their central responsibilities. In particular, they believed that if they were to close the income gap between themselves and the more-developed countries, they had to close the knowledge and technology gap. So they designed education and investment policies to do that. While the Washington Consensus' policies paid little attention to inequality, they believed that such policies were important for maintaining social cohesion, and that social cohesion was necessary to provide a climate favorable to investment and growth.

When the crisis began, those in the West did not realize its severity. Asked about aid for Thailand, President Bill Clinton dismissed the collapse of the baht as "a few glitches in the road" to economic prosperity. Clinton's confidence and imperturbability was shared by other world financial leaders who attended the annual meeting of the IMF and the World Bank in Hong Kong in September 1997. IMF officials were so sure of their advice that they even asked for a change in its charter to allow them to put more pressure on developing countries to liberalize capital markets.

Meanwhile, Asian leaders were terrified. They viewed the hot money that came with liberalized capital markets as the source of their problems. They knew that major trouble was ahead. They feared that IMF policies

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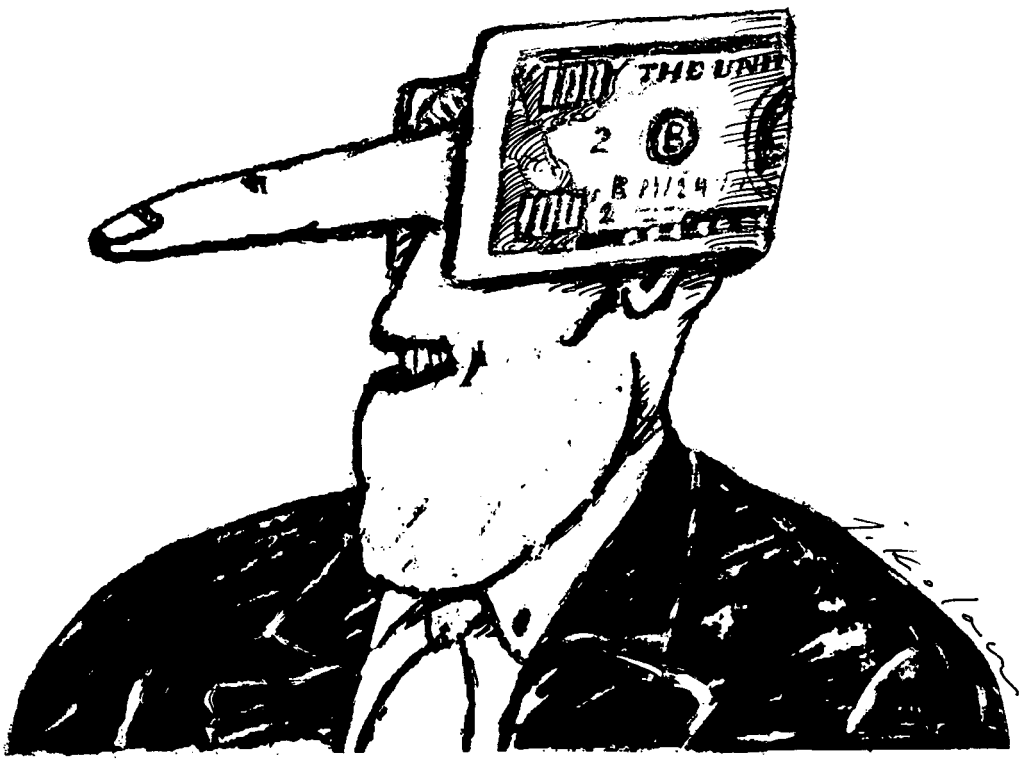

would prevent them from taking the actions needed to stave off the crisis, and that the policies the IMF would insist upon should a crisis occur would worsen the impact. But they felt powerless to resist. In the end, only Malaysia was brave enough to risk the wrath of the IMF. And though Prime Minister Mahathir Mohamad's policies – keeping interest rates low, putting brakes on the rapid outflow of speculative money – were attacked from all quarters, Malaysia's downturn was shorter and shallower than that of the other countries.

At the Hong Kong meeting, I suggested to the ministers of the Southeast Asian countries that there were some concerted actions they could take together. If they all imposed capital controls in a coordinated way, they might be able to withstand the pressures that would undoubtedly be brought down upon them by the international financial community, and they could help insulate their economies from the turmoil. They talked about getting together later in the year to map out a plan. But hardly had their bags been unpacked from the trip to Hong Kong than the crisis spread – first to Indonesia, and then, in early December, to South Korea. Meanwhile, countries from Brazil to Hong Kong had been attacked by currency speculators, and withstood the attack at high cost.

There are two familiar patterns to these crises. The first is illustrated by South Korea. As it emerged from the wreckage of the Korean War, South Korea formulated a growth strategy that increased per capita income eightfold in 30 years, reduced poverty dramatically, achieved universal literacy, and

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went far in closing the gap in technology between itself and the more advanced countries. By the beginning of the 1990s, South Korea had become one of the world's largest producers of computer chips, and its large conglomerates produced goods known throughout the world.

But whereas in the early days of its transformation Korea had tightly controlled financial markets, under pressure from the United States it had reluctantly allowed its firms to borrow abroad. The firms thus exposed themselves to the vagaries of the international market. In late 1997, rumors flashed through Wall Street that Korea was in trouble. Such rumors can be self-fulfilling prophecies. The banks, which a short time earlier were so eager to lend money to Korean firms, decided not to roll over their loans. Their prophecy thus came true: Korea was in trouble.

The second was illustrated by Thailand. There, a speculative attack combined with high short-term indebtedness was to blame. Speculators who believe a currency will devalue try to move out of the currency and into dollars; with free convertibility this can easily be done. But as traders sell the currency, its value is weakened – confirming their prophecy. Alternatively, and more commonly, the government tries to support the currency. It sells dollars from its reserves, buying up the local currency to sustain its value. But eventually the government runs out of hard currency. The currency plummets. The speculators are satisfied. If the crises had a familiar pattern, so too did the IMF's responses: it loaned huge amounts of money so that the countries could sustain their exchange rates. It thought that if the market believed that there was enough money in the coffers, there would be no point in attacking the currency, and thus confidence would be restored.

Ordinary people as well as many government officials and business people continue to refer to the economic and social storm that hit their nations simply as "the IMF" – the way one would say "the plague" or "the Great Depression."

The money served a second function: enabling the countries whose firms had borrowed from Western bankers to repay the loans. It was thus a bailout to the international banks as much as it was a bailout to the borrowers. And in country after country in which the IMF money was used to sustain the exchange rate temporarily at an unsustainable level, rich people took advantage of the opportunity to convert their money into dollars at the favorable exchange rate and whisk it abroad.

The IMF combined the money with conditions in packages that were supposed to rectify the problems that caused the crisis. It is these other ingredients, as much as the money, that were supposed to persuade markets to roll over their loans, and to persuade speculators to look elsewhere for easy targets. The ingredients typically include higher interest rates – in the case of East Asia, much, much higher rates – and cutbacks in govern-

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ment spending and increases in taxes. Additional conditions required countries to make political as well as economic changes – major reforms, including increased openness and transparency, and improved financial-market regulation.

The IMF would claim that imposing these conditions was the responsible thing to do. It was providing billions of dollars; it had a responsibility to make sure that the countries did the right thing to restore their economic health.

The programs failed. Exchange rates continued to fall, with hardly a flicker of recognition by the markets that the IMF had come to the rescue. In each case, an embarrassed IMF charged the country with failing to take reforms seriously. In each case, it announced there were fundamental problems that had to be addressed before a true recovery could take place. Investors, more convinced by the diagnosis of the problems than by the prescriptions, fled. Rather than restoring confidence that would lead to an inflow of capital, IMF criticism exacerbated the stampede of capital out.

Because of this, the perception throughout much of the developing world is that the IMF itself had become a part of the countries' problem rather than part of the solution. Indeed, in several countries in crisis, ordinary people as well as many government officials and business people continue to refer to the economic and social storm that hit their nations simply as "the IMF" – the way one would say "the bubonic plague" or "the Great Depression."

As the crisis progressed, unemployment soared, GDP plummeted and banks closed. In Indonesia, almost 15 percent of males working in 1997 had lost their jobs by August 1998. In South Korea, urban poverty almost tripled. In 1998, GDP in Indonesia fell by 13.1 percent, in Korea by 6.7 percent, and in Thailand by 10.8 percent. Three years later, Indonesia's GDP was still 7.5 percent below what it was before the crisis, Thailand's 2.3 percent lower. The erosion of the middle class, caused by usurious interest rates that threw small businesses into bankruptcy, will have the most enduring effects on the social, political and economic life of the region.

With the slowing of global economic growth, commodity prices fell. From Russia to Nigeria, the many emerging countries that depended on natural resource exports were in deep, deep trouble. As investors who had risked their money in these countries saw their wealth plummeting, and as their bankers called in their loans, they had to cut back their investments in other emerging markets. Brazil, dependent on neither oil nor on trade with the countries in deep trouble, and with economic features far different from these countries, was brought into the unfolding global financial crisis by the generalized fear among foreign investors. Eventually, almost every emerging market was affected.

HOW IMF/U.S. TREASURY POLICIES LED TO THE CRISIS

The disturbances capped a half-decade of an American-led global triumph of market economics following the end of the cold war. Investors saw newly emerging markets, from East Asia to Latin America to Russia to India, as a paradise of high returns and seemingly low risk. Private capital flows from the developed to the less developed countries increased seven-fold in seven years

The IMF and the United States Treasury argued that full capital-account liberalization would help the region grow even faster. The countries in East Asia had no need for additional capital, given their high savings rate, but still capital-account liberalization was

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pushed on these countries in the late 80s and early 90s.

I believe that capital-account liberalization was the single most important factor leading to the crisis. It has also become increasingly clear that all too often capital-account liberalization represents risk without a reward. Even when countries have strong banks, a mature stock market, and other institutions that many of the Asian countries did not have, it can impose enormous risks.

Probably no country could have withstood the sudden change in investor sentiment that reversed the huge inflow of capital. In the case of Thailand, this reversal amounted to 7.9 percent of GDP in 1997, 12.3 percent of GDP in 1998, and 7 percent of GDP in the first half of 1999. While developing countries' ability to withstand the reversal was weak, so, too, was their ability to cope with the consequences of a major downturn.

Their remarkable economic performance meant that the East Asian countries had not developed unemployment insurance plans. But even had they turned their mind to the task, it would not have been easy. Even in the United States, unemployment insurance for those who are self-employed in agriculture is far from adequate, and this is precisely the sector that dominates economies in the developing world.

The complaint against the IMF, however, runs deeper; it is not just that it pushed the liberalization policies that led to the crisis, but in addition that it pushed these policies even though there was little evidence that they promoted growth and there was ample evidence that they imposed huge risks.

In October 1997, the IMF was advocating the expansion of precisely those polices that underlay the increasing frequency of crises. As an academic, I was shocked that the IMF and the U.S. Treasury would push this agenda with such force in the face of a virtual absence of theory and evidence suggesting that it was in the economic interests of either the developing countries or global economic stability. Surely, one might have argued, there must be some basis for their position beyond serving the naked self-interest of lenders and investment bankers.

The advocates of capital-market liberalization came up with an argument that even at the time I thought was unconvincing, but in retrospect looks particularly strange – namely, that it would enhance the countries' economic stability! This was to be achieved by allowing greater diversification of sources of funding.

It is hard to believe that these advocates had not seen the data that showed that capital flows were procyclical – capital flows out of a country in a recession, precisely when the country needs it most, and flows in during a boom, exacerbating inflationary pressures. Sure enough, just at the time the countries needed outside funds the bankers asked for their money back.

There was a second, hardly more credible argument put forward by the advocates of capital-market liberalization. They contended that capital market controls impeded economic efficiency and that, as a result, countries would grow faster without these controls.

Before liberalization, Thailand had severe limitations on the extent to which banks could lend for speculative real estate. It had imposed these limits because it believed that investing the country's scarce capital in manufacturing would both create jobs and enhance growth. It also knew that throughout the world, speculative real estate lending gives rise to bubbles. These bubbles always burst, and when they do, the economy crashes.

The IMF, however, contended that the kinds of restraints Thailand had imposed to

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prevent a crisis interfered with efficient market allocation. If the market says build office buildings, commercial construction must be the highest-return activity. While Thailand was desperate for more public investment to strengthen its infrastructure and relatively weak secondary and university education systems, billions were squandered on commercial real estate. These buildings remain empty today, sad testimony to the risks posed by excessive market exuberance and the pervasive market failures that can arise in the presence of inadequate regulation of financial institutions.

THE FIRST ROUND OF MISTAKES

There is little doubt that IMF and U.S. Treasury policies contributed to an environment that enhanced the likelihood of a crisis by encouraging – in some cases insisting on – rapid financial and capital-market liberalization. However, the IMF and Treasury made their most profound mistakes in their initial response to the crisis.

At the onset, the IMF seemed to have misdiagnosed the problem. It had handled crises in Latin America that were caused by profligate government spending and loose monetary policies, which led to huge deficits and high inflation. And while it may not have handled those crises well – the region experienced a decade of stagnation after IMF intervention – it at least had a game plan with some coherency. East Asia was vastly different from Latin America; governments ran surpluses and economies enjoyed low inflation,

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but corporations were deeply indebted.

The diagnosis made a difference for two reasons. First, in East Asia the problem was not excess demand for goods and services but insufficient demand. Thus dampening demand could only make matters worse. Second, if firms have a low level of indebtedness, high interest rates can be absorbed. But with high levels of indebtedness, imposing high interest rates is like signing a death warrant for many firms – and for the economy.

While the Asian economies did have some weaknesses that needed to be addressed, they were no worse than those in many other countries – and surely nowhere near as bad as the IMF suggested. Indeed, the rapid recovery of South Korea and Malaysia showed that, in large measure, the downturns were not unlike the dozens of recessions that have plagued market economies in the advanced industrial countries in 200 years of capitalism. If East Asia was vulnerable, it was largely the result of the financial-market liberalization for which the IMF was itself partly culpable.

Hooverite Contractionary Policies: An Anomaly in the Modern World

For more than 70 years, there has been a standard recipe for a country facing a severe economic downturn. The government must stimulate aggregate demand by cutting taxes, increasing expenditures, or loosening monetary policy. The crisis economies of East Asia were clearly threatened with a major downturn and needed stimulation. The IMF pursued the opposite course, with predictable consequences.

At the onset of the crisis, East Asia was in rough macro balance, with low inflationary pressures and government budgets in balance or having a surplus. This had two obvious implications. First, the collapse of the exchange rate and the stock markets, the breaking of the real estate bubbles, accompanied by falling investment and consumption, would send it into a recession. Second, the economic collapse would result in collapsing tax revenues, and leave a budget gap. Not since Herbert Hoover's administration have responsible economists argued that one should focus on the actual deficit rather than the structural deficit – that is, the deficit that would have been there had the economy been operating at full employment. Yet this is precisely what the IMF advocated.

Today, the IMF admits that the fiscal policy it recommended was excessively austere. During the crisis, however, Stanley Fischer, the IMF's first deputy managing director, defended the IMF's policies, writing, in effect, that all the IMF was asking of the countries was to balance their budgets! Not for 60 years have respectable economists believed that an economy going into a recession should balance its budget.

Beggar-Thyself Policies

Of all the mistakes the IMF committed as the East Asian crisis spread in 1997 and 1998, one of the hardest to fathom was its failure to recognize the important interactions among the policies pursued in the different countries. By continuing to advocate contractionary policies, the IMF exacerbated the spread of the downturn from one country to the next.

The beggar-thy-neighbor policies of the 1930s are generally thought to have played an important role in the spread of the Great Depression. Each country tried to bolster its own economy by cutting back on imports and thus shifting consumer demand to its own products. However, as each country cut back on imports, it succeeded in exporting the economic downturn to its neighbors.

The IMF devised a strategy whose effect was even worse. Countries were told that

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when facing a downturn, they must cut their trade deficits, and even build surpluses. The IMF also inveighed strongly against further devaluation. Indeed, the whole point of the bailouts was to prevent a further decrease in the exchange rate. This itself might seem peculiar, given the IMF's faith in markets. Why not let market mechanisms determine exchange rates, just as they determine other prices? But intellectual consistency has never been the hallmark of the IMF, and its single-minded worries about inflation being set off by devaluation have always prevailed.

With tariffs and devaluations ruled out, there were but two ways to build a trade surplus. One was to increase exports. But this is not easy when the economies of your major trading partners are weak and your own financial markets are in disarray, which means that exporters cannot obtain capital with which to expand. The other was to reduce imports by cutting domestic demand – that is, by inducing a recession. Unfortunately this is what happened in East Asia in the late 1990s. Contractionary fiscal and monetary policies combined with misguided financial policies led to massive economic downturns, which led to huge trade surpluses and gave the countries the resources to pay back foreign creditors.

If one's objective was to increase the size of reserves, the policy was a success. But at what expense to the people in the country, and their neighbors! The consequence for any country's trading partners was exactly the same as if beggar-thy-neighbor policies had actually been pursued. Each country's imports were cut back, which is the same as other countries' exports being cut. From the neighbors' perspectives, they couldn't care less why exports were cut; what they saw was the consequence – a reduction of sales abroad.

In focusing on protecting investors, it had forgotten about those in the countries it was supposed to be helping.

Thus, the downturn was exported around the region. Slower growth in the region led to a collapse in commodity prices, and the collapse in those prices wrought havoc in oil-producing countries like Russia.

Of all the failures of the IMF this is perhaps the saddest because it represented the greatest betrayal of its raison d'être. More generally, the IMF's performance as market psychologist left something to be desired. Creating deep recessions with massive bankruptcies and/or pointing out deep-seated problems in the best-performing region of the emerging markets are policies hardly designed to restore confidence. In focusing on protecting investors, it had forgotten about those in the countries it was supposed to be helping; in focusing on financial variables like exchange rates, it had almost forgotten about the real side of the economy. The IMF had lost sight of its original mission.

Strangling an Economy with High Interest Rates

Today, the IMF agrees that the fiscal policies it pushed were excessively contractionary, but it does not own up to its mistakes in monetary

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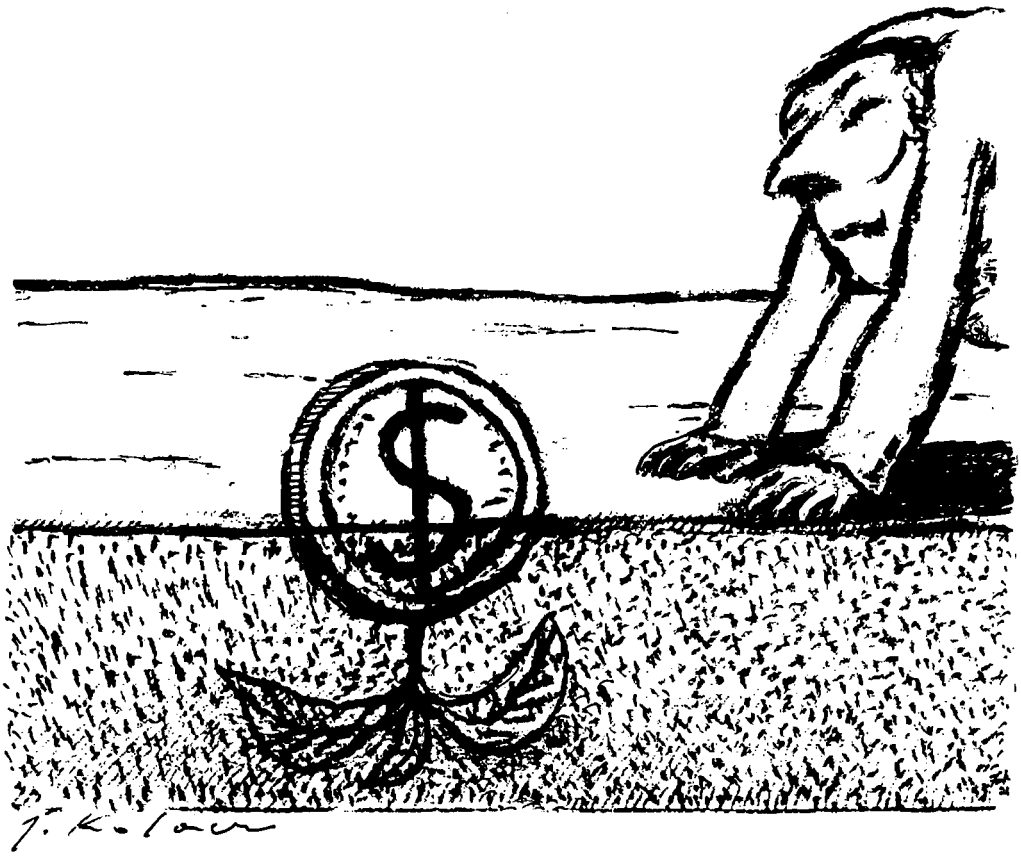

policy. When the IMF entered East Asia, it forced countries to raise interest rates to what, in conventional terms, would be considered astronomical levels. I remember meetings where President Clinton was frustrated that the Federal Reserve Bank was about to raise interest rates one-quarter or one-half percentage point. Yet in East Asia, IMF bureaucrats, who were even less politically accountable, forced interest rate increases not 10 but 50 times greater – interest rate increases of more than 25 percentage points.

The reasoning behind these policies was simple, if not simplistic. If a country raised interest rates, it would make it more attractive for capital to flow into that country. Capital flows into the country would help support the exchange rate and thus stabilize the currency. End of argument.

At first glance, this appears logical. However, recall that in South Korea the crisis was started by foreign banks refusing to roll over their short-term loans because they worried about South Korean firms' ability to repay. Bankruptcy – default – was at the center of the discussion. But in the IMF model, bankruptcy plays no role. To discuss monetary policy and finance without bankruptcy is like Hamlet without the Prince of Denmark. Many of the firms in East Asia were highly indebted, and had huge debt-to-equity ratios. Indeed, even the IMF had repeatedly cited the excessive leverage as one of South Korea's weaknesses. At very high interest rate levels, a highly leveraged company goes bankrupt quickly.

In defending its policies, the IMF said they would help restore market confidence. But

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clearly, deep recessions do not inspire confidence. On the contrary, the higher rates made the recession worse and actually drove capital out of the country.

The IMF came up with another defense of no more validity. It argued that if interest rates were not greatly increased, the exchange rate would collapse and those with dollar-denominated debts would not be able to repay them. But raising interest rates did not stabilize the currencies. Moreover, the IMF never bothered to look at the details of what was going on inside the countries. In Thailand, for instance, it was the already-bankrupt real estate firms and those that lent to them that had the most foreign-denominated debt. Further devaluations would not have made these firms any more dead. In effect, the IMF made the small businesses and other innocent bystanders pay for those who had engaged in excessive dollar borrowing – and to no avail.

In Indonesia, an estimated 75 percent of all businesses were put into distress, while in Thailand close to 50 percent of bank loans became nonperforming loans. Unfortunately, it is far easier to destroy a firm than to create a new one. Lowering interest rates would not unbankrupt a firm that had been forced into bankruptcy; its net worth would still have been wiped out. The IMF's mistakes were costly, and slow to reverse.

Naive geopolitical reasoning, vestiges of Kissinger-style realpolitik, compounded the consequences of these mistakes. In 1997, Japan offered $100 billion to help create an Asian Monetary Fund to finance the required stimulative actions. But the U.S. Treasury did everything it could to squelch the idea. The IMF joined in.

The reason was clear: while the IMF was a strong advocate of competition in markets, it did not want competition in its own domain, and the Asian Monetary Fund would have provided that. The U.S. Treasury's motivations were similar. As the only shareholder of the IMF with veto power, the United States had considerable say in IMF policies. It was widely known that Japan disagreed strongly with the IMF's actions – I had repeated meetings with senior Japanese officials in which they expressed misgivings that were almost identical to my own. With Japan, and possibly China, as the likely major contributors to the Asian Monetary Fund, their voices would predominate, providing a real challenge to American leadership – and control.

Eventually, Secretary of the Treasury Lawrence Summers and Stanley Fischer at the IMF could not ignore the depression. Japan once again made a generous offer to help under the Miyazawa Initiative, named after Japan's finance minister. This time, the offer was scaled down to $30 billion, and was accepted. But even then, the United States argued that the money should be spent not to stimulate the economy through fiscal expansion, but for corporate and financial restructuring – effectively, to bail out American and other foreign banks and other creditors.

The squashing of the Asian Monetary Fund is still resented in Asia and many officials have spoken to me angrily about the incident. Three years after the crisis, the countries of East Asia finally got together to begin, quietly, the creation of a more modest version of the Asian Monetary Fund, under the innocuous name of the Chiang Mai Initiative.

THE SECOND ROUND OF MISTAKES: BUMBLING RESTRUCTURING

As the crisis worsened, the need for restructuring became the IMF's new mantra. Banks that had bad loans on their books should be shut down, while companies that owed money should be closed or taken over by their

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creditors. The IMF focused on this rather than simply performing the role it was supposed to fill – providing liquidity to finance needed expenditures. Alas, even this focus on restructuring failed, and much of what the IMF did helped push the sinking economies down further.

Financial Systems

The East Asia crisis was, first and foremost, a crisis of the financial system. The financial system can be compared to the brain of the economy. It allocates scarce capital among competing uses by trying to direct it to where it is most effective – in other words, where it yields the highest returns. If the financial system breaks down, firms cannot get the working capital they need to continue existing levels of production, let alone finance expansion through new investment.

A crisis can give rise to a vicious circle wherein banks cut back credit, leading firms to cut back on their production – which in turn leads to lower output and lower incomes. As output and incomes plummet, profits fall and some firms are forced into bankruptcy. When firms declare bankruptcy, banks' balance sheets become weaker and the banks cut back lending even further, exacerbating the economic downturn.

If enough firms fail to repay their loans, banks may even collapse. A collapse of even a single large bank can have disastrous consequences. Financial institutions determine creditworthiness. This information is highly specific, cannot easily be transmitted, and is embedded in the records and institutional memory of the bank. When a bank goes out of business much of the creditworthiness information it has on its borrowers is destroyed, and that information is expensive to recreate.

Even in more advanced countries, a typical small- or medium-sized enterprise may obtain credit from at most two or three banks. When a bank goes out of business, many of its customers have difficulty finding an alternative supplier of credit overnight. In developing countries, finding a new source of funds may be nearly impossible.

Fears of this vicious circle have induced governments to strengthen their financial systems through prudent regulation. Repeatedly, free marketers have bridled against these regulations. When their voices have been heeded the consequences have been disastrous – whether in Chile in 1982 and 1983, in which gross domestic product fell by 13.7 percent and one in five workers was unemployed, or the United States in the Reagan era, where deregulation led to the $200 billion savings and loan debacle.

Recognition of the importance of maintaining credit flows has similarly guided policymakers in trying to deal with the problems of financial restructuring. Fears about the adverse effects of this destruction of informational capital partially explain why the United States closed down very few banks outright during the savings and loan debacle. Even so, that crisis was an important contributing factor to the 1991 recession.

Inducing a Bank Run

Although financial-system weaknesses were pervasive in East Asia and the IMF's rhetoric focused on these weaknesses, the IMF failed to understand how financial markets work and how they affect the rest of the economy. Its crude macro models never embraced a broad picture of financial markets at the aggregate level, but were even more deficient at the firm level, never adequately taking into account the corporate and financial distress to which its so-called stabilization policies contributed so strongly.

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IMF teams in East Asia focused on shutting weak banks. There was some basis for their position. Elsewhere, allowing weak banks to continue to operate without tight supervision resulted in their making highly risky loans. All too often, such risky loans turn out to be bad loans, and when the day of reckoning comes, the government faces an even bigger bailout than if the bank had been shut earlier. But the IMF overlooked another critical lesson of the United States savings and loan crisis: the importance of keeping credit flowing.

Its strategy for financial restructuring involved triage – separating the really sick banks from the healthy banks and the ones that were sick but reparable. Banks are required to have a certain ratio of capital to their outstanding loans and other assets; this ratio is termed the capital adequacy ratio. The IMF insisted that banks either shut down or quickly meet this capital adequacy ratio. But this exacerbated the downturn.

When only one bank has a problem, insisting on it meeting its capital adequacy standards makes sense. But when many banks are in trouble, that policy can be disastrous. There are two ways of increasing the ratio of capital to loans: increasing capital or reducing loans. In the midst of a downturn, especially of the magnitude of that in East Asia, it is hard to raise new capital. The alternative is to reduce outstanding loans. But as each bank calls in its loans, more and more firms are put into distress. Without adequate working capital, they are forced to cut back on their production, cutting into the demand for products from other firms. And with more firms in distress, the capital adequacy ratio of banks can even be worsened.

Although financial system weaknesses were pervasive in East Asia and the IMF's rhetoric focused on these weaknesses, it failed to understand how financial markets work and how they affect the rest of the economy.

With a large number of banks shut down, and with those managing to survive unwilling to take on new customers, more businesses found themselves without access to credit. The depreciation of the region's currencies meant that exports should have boomed, as the goods from the region became cheaper by 30 percent or more. But while export volumes increased, they did not increase nearly as much as expected, and for a simple reason: as banks cut back on their lending, firms could not get the working capital required to expand production.

Nowhere was the IMF's lack of understanding of financial markets as evident as in its policies in Indonesia. There, some 16 private banks were closed, and notice was given that other banks might be subsequently shut as well; but depositors, except for those with very small accounts, would be left without a means to recover their assets. Not surprisingly this engendered a run on the remaining

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private banks, and deposits were quickly shifted to state banks, which were thought to be protected by an implicit government guarantee. The effects were disastrous, compounding the mistakes in fiscal and monetary policy already discussed, and almost sealing that country's fate.

misguided economics conspired with ideology and special interests to dampen the pace of restructuring.

The IMF's strategy for corporate restructuring was no more successful than its strategy for restructuring banks. It confused financial restructuring with real restructuring – the

Riots do not restore business confidence. They drive capital out of a country; they do not attract capital into a country.

In contrast, South Korea ignored outside advice, and recapitalized its two largest banks, rather than closing them down. This is part of why Korea recovered relatively quickly.

Corporate Restructuring

While attention focused on financial restructuring, it was clear that the problems in the financial sector could not be resolved unless the problems in the corporate sector were effectively addressed. With 75 percent of the firms in Indonesia in distress and half of the loans in Thailand classified as nonperforming, the corporate sector was entering a stage of paralysis. Firms facing bankruptcy are in a state of limbo: it is not clear who really owns them, the current owners or the creditors. But without clear owners, there is always a temptation for current management and the old owners to strip assets.

When companies go into bankruptcy in the United States, trustees are appointed by the courts to prevent this. But in Asia there were neither the legal frameworks nor the personnel to implement trusteeships. It was thus imperative that bankruptcies and corporate distress be resolved quickly, before stripping could occur. Unfortunately, the IMF's nuts-and-bolts decisions about what the firm should produce and how. In a massive economic downturn like this one, there were real macro benefits from rapid financial restructuring. It was thus imperative that the government do whatever it could to facilitate a quick resolution.

I took the view that the government should play an active role in pushing this financial restructuring, ensuring that there were real owners at the helm. Once ownership issues were resolved, the new owners could set about the task of deciding the issues of real restructuring. The IMF took the opposite view, saying that the government should not play an active role in financial restructuring, but push for real restructuring – selling assets, for example, to reduce the apparent excess capacity in computer chips in South Korea and bringing in outside (typically foreign) management. I saw no reason to believe that international bureaucrats, trained in macro management, had any special insight into corporate restructuring in general, or the chip industry in particular.

The governments of South Korea and Malaysia took an active role and succeeded in completing the financial restructuring of a

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remarkably large fraction of the firms in distress in two years. Restructuring in Thailand, which followed the IMF strategy, languished.

THE MOST GRIEVOUS MISTAKES: RISKING SOCIAL AND POLITICAL TURMOIL

The social and political consequences of mishandling the Asian crisis may never be measured fully. While the IMF had provided some $23 billion to Indonesia to stabilize the exchange rate and bail out creditors, the far, far smaller sums required to help the poor were not forthcoming. The day after food and fuel subsidies for the poor in Indonesia were drastically cut back, riots exploded. As had happened 30 years earlier, Indonesian business executives and their families became the victims. Even if one cared little for those who faced starvation, it was simply bad economics. Riots do not restore business confidence. They drive capital out of a country; they do not attract capital into a country.

After the riots in Indonesia, food subsidies were restored. But again, the IMF showed that it had not learned the lesson of irreversibility. Just as a firm that was bankrupted by the high interest rates does not become unbankrupted when interest rates are lowered, a society that is rendered asunder by cutting out food subsidies is not brought together when the food subsidies are restored. Indeed, in some quarters, the bitterness is all the greater: if the food subsidies could have been afforded, why were they taken away in the first place?

RECOVERY: VINDICATION OF IMF POLICIES?

As this book goes to press many Asian countries are growing again, their recoveries only slightly stalled by the global slowdown that began in 2000. But although some at the IMF believe their interventions were successful, it is widely agreed that serious mistakes were made. The Asian crisis was more severe than it should have been, recovery took longer than it needed to, and prospects for future growth are not what they should be.

There is no true recovery until workers return to their jobs and wages are restored to precrisis levels. Today, incomes in the countries of East Asia affected by the crisis are still 20 percent below what they would have been had their growth continued at the pace of the previous decade. In Indonesia, output in 2000 was still 7.5 percent lower than in 1997, and even Thailand, the IMF's best pupil, had not attained its precrisis output – let alone made up for the lost growth.

This is not the first instance of the IMF declaring victory prematurely – Mexico's crisis in 1995 was declared over as soon as the banks and international lenders started to get repaid. But five years after the crisis, workers were just getting back to where they were beforehand. The very fact that the IMF focuses on financial variables, not on real wages, unemployment, GDP or broader measures of welfare is telling.

The question of how best to manage a recovery is difficult, and the answer clearly depends on the cause of the problem. Sometimes, as in Latin America during the 1970s, crises are caused by governments spending beyond their means. And in those cases, the government will need to cut back expenditures or increase taxes – decisions that are painful, at least in the political sense. But because East Asia had neither loose monetary policies nor profligate public sectors, those were not the right measures for dealing with its crisis.

The problem with the IMF's mistakes is that the consequences are likely to be long lasting. The IMF often talked as if what the economy needed was a good purgative.

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According to the IMF, then, a country concerned about its long-run prospects should swallow hard and accept a deep downturn. But the evidence does not support the IMF's theory. An economy that has had a deep recession may grow faster as it recovers, but it never makes up for the lost time.

There is an important implication: the deeper the recession today, the lower output is likely to be for years to come. In a way this is good news, since it means that the best medicine for today's economy and the best medicine for tomorrow's coincide. It implies that economic policy should be directed at minimizing the depth and duration of any economic downturn. Unfortunately, this was neither the intention nor the impact of the IMF prescriptions.

Malaysia and China

Though Prime Minister Mahathir's rhetoric and human rights policies often leave much to be desired, many of his economic policies were a success. Early on in the 1997 crisis, Michael Camdessus, then the IMF chief, announced that Malaysia's banks were in a weak position. He was wrong. While there was a high level of nonperforming loans (15 percent), Malaysia's central bank had imposed strong regulations that had resulted in banks making adequate provisions for these losses. Moreover, Malaysia' strong regulatory stance had protected banks from exposure to the exchange rate risk of borrowing in dollars and lending in ringgit, and had even limited the foreign indebtedness of the companies to which these banks lent.

Few banking systems could survive a long recession, or a depression, and Malaysia's was no exception. But Malaysia's banking system was remarkably strong. Within Malaysia, the issue of the appropriate response to the crisis was hotly debated. The finance minister, Anwar Ibrahim, proposed an IMF program without the IMF – that is, raising interest rates and cutting back on expenditures. Mahathir remained skeptical. Eventually, he dumped his finance minister and reversed his economic policies.

As the regional crisis grew into a global crisis and international capital markets went into a seizure, Mahathir acted again. In September 1998, Malaysia pegged the ringgit at 3.80 to the dollar, cut interest rates, and decreed that all offshore ringgit be repatriated by the end of the month. The government also imposed tight limits on transfers of capital abroad by residents and froze the repatriation of foreign portfolio capital for 12 months.

Some economists – those from Wall Street, joined by the IMF – expected foreign investment to plummet, the stock market to fall, and a black market to form in the ringgit, with its accompanying distortions. And, they warned, while the controls would lead to a drying up of capital inflows, they would be ineffective in stopping capital outflows. Even Treasury Secretary Robert Rubin, usually of such quiet demeanor, joined in the communal tongue-lashing.

In fact, the outcome was far different. Since rapid capital flows into or out of a country cause large disturbances, government has the right – even the obligation – to take measures to address such disturbances. In general, economists believe that market-based interventions like taxes are more effective and have fewer adverse side effects than direct controls. So we at the World Bank encouraged Malaysia to drop direct controls and impose an exit tax.

Malaysia removed the tax one year after the imposition of controls, just as it had promised. In the interim, Malaysia had restructured its banks and corporations. Indeed, it

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had made far more progress in that direction than Thailand, which followed the IMF prescriptions.

In retrospect, it was clear that Malaysia's capital controls allowed it to recover more quickly, with a shallower downturn and with a far smaller legacy of national debt to burden future growth. The controls allowed it to have lower interest rates than it could otherwise have had; the lower interest rates meant that fewer firms were put into bankruptcy, and so the magnitude of publicly funded corporate and financial bailout was smaller.

The lower interest rates also meant that recovery could occur with less reliance on fiscal policy, and consequently less government borrowing and less debt. Today, Malaysia stands in a far better position than those countries that took the IMF's advice. There was little evidence that the capital controls discouraged foreign investors. Foreign investment actually increased.

It is no accident that the two large developing countries spared the ravages of the global economic crisis – India and China – both had capital controls. While developing countries with liberalized capital markets actually saw their incomes decline, India's grew at a rate in excess of 5 percent and China's at close to 8 percent. This is all the more remarkable given the overall slowdown in world growth and trade during that period.

China achieved this by following the prescriptions of economic orthodoxy: when faced with an economic downturn, respond with expansionary macroeconomic policy. China seized the opportunity to combine its short-run needs with long-run growth objectives, investing heavily in long-delayed public infrastructure, with high returns.

In making economic policy decisions, China was aware of the link between macro stability and its microeconomy. It knew that it needed to continue restructuring its corporate and financial sector. However, it also recognized that an economic slowdown would make it all the more difficult to proceed with a reform agenda.

Though the differences in individual circumstances make the reasons either for the occurrence of a crisis or for quick recovery hard to ascertain, I think it is no accident that China, the only major East Asian country to avoid the crisis, took a course directly opposite that advocated by the IMF, and that Malaysia, the country with the shortest downturn, also explicitly rejected an IMF strategy.

Korea, Thailand and Indonesia

South Korea and Thailand provide further contrasts. After a short period of vacillation, Thailand followed IMF prescriptions almost to the letter. Yet more than three years after the beginning of the crisis, it was still in recession, with a GDP 2.3 percent below the pre-crisis level. Little corporate restructuring had taken place, and close to 40 percent of loans were still nonperforming ones.

In contrast, South Korea did not close down banks and the Korean government took an active role in restructuring corporations. Moreover, Korea kept its exchange rate low in order to sustain exports and limit imports. And it did not follow the IMF's advice concerning physical restructuring. The IMF argued that Korea should quickly get rid of the excess capacity in computer chips. Korea ignored this advice, and as the demand for chips recovered, the economy recovered.

In evaluating the recoveries, most analysts put Indonesia aside because its economy has been dominated by political events and social turmoil. However, as we have seen, the political and social turmoil are themselves attributable in no small measure to IMF policies. No one will know whether there could have been

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a more graceful transition from Suharto, but few would doubt that it could have been more tumultuous.

Effects on the Future

East Asian countries will undoubtedly develop better financial regulatory systems, and better financial institutions overall. Though its firms had already demonstrated a remarkable ability to compete in the global marketplace, South Korea is likely to emerge with a more competitive economy.

However, the manner in which the crisis was addressed – particularly the use of high interest rates – is likely to affect the region's intermediate, and possibly long-term, economic growth adversely.

While East Asia's banks were far from perfect, their achievements in allocating the enormous flows of capital in preceding decades were, in fact, quite impressive. Although the intention of those pushing for reforms in East Asia was to improve the ability of the financial system to allocate resources, in fact, the IMF's policies are likely to have impaired the overall efficiency of the market.

EXPLAINING THE MISTAKES

While the IMF now agrees it made serious mistakes in a variety of areas, it has not admitted to mistakes in its monetary policy. Nor has it even sought to explain why its models failed to predict the course of events so miserably.

Part of the explanation of the magnitude of the failures has to do with hubris. No one likes to admit a mistake, especially a mistake of this magnitude or with these consequences. Neither Fischer nor Summers, neither Rubin nor Camdessus, wanted to think that their policies were misguided. They stuck to their positions, in spite of overwhelming evidence of their failure.

But in Asia other theories abound, including a conspiracy theory (which I do not share) that views the policies either as a deliberate attempt to weaken East Asia or at least to enhance the incomes of those on Wall Street and the other money centers. One can understand how this line of thinking developed: the IMF first told countries in Asia to open up their markets to hot short-term capital. The countries did it and money flooded in – but just as suddenly flowed out. The IMF then said interest rates should be raised and there should be a fiscal contraction, and a deep recession was induced.

As asset prices plummeted, the IMF urged affected countries to sell their assets, even at bargain basement prices. It said the companies needed solid foreign management, and that this would only happen if the companies were sold to foreigners, not just managed by them.

The sales were handled by the same foreign financial institutions that had pulled out their capital, precipitating the crisis. These banks then got large commissions from their work selling the troubled companies or splitting them up, just as they had when they originally guided the money into the countries in the first place. Some of these American and other financial companies didn't do much restructuring; they just held the assets until the economy recovered, making profits from buying at the fire sale prices and selling at more normal prices.

I don't believe the IMF was participating in a conspiracy, but it was reflecting the interests and ideology of the Western financial community. Secretive modes of operation insulated the institution and its policies from the kind of intensive scrutiny that might have forced it to adopt policies that were appropriate to East Asia.

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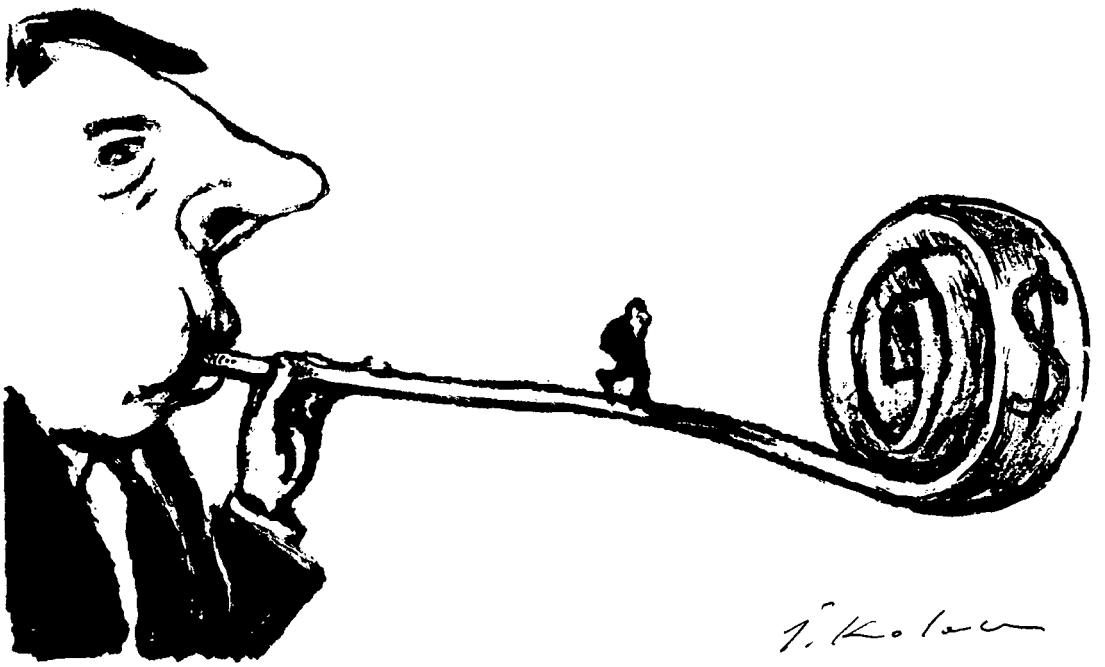

AN ALTERNATIVE STRATEGY

My critics have rightly asked what I would have done instead. I agreed with the IMF on the importance of financial restructuring. But I would have approached it with the primary objective of maintaining the flow of finance and a standstill on existing debt repayment. A key part of corporate restructuring would entail the implementation of a special bankruptcy provision. United States bankruptcy law allows for relatively quick Chapter 11 reorganization of a firm, rather than liquidation. Bankruptcies induced by macroeconomic disturbances, as in East Asia, call for an even faster resolution – what I call super-Chapter 11.

With or without such a provision, strong intervention of government was required. But the intervention of the government would have aimed at financial restructuring – establishing clear ownership of firms, enabling them to re-enter credit markets. Such financial restructuring did not require huge bailouts. I cannot be sure that my ideas would have worked. But the chance of success with this strategy was far greater than with the IMF's plan, which failed in ways that were perfectly predictable and very costly.

The Asian crisis has brought many changes that will stand the countries in good stead in the future. Corporate governance and accounting standards have improved – in some cases bringing these countries to the top of the emerging markets. The new constitution in Thailand promises a level of transparency certainly beyond that of the international financial institutions. But the way the IMF approached the crisis has left a legacy of private and public debt. Capital markets will work less efficiently and the growth of living standards will be slowed. Indeed, the IMF policies in East Asia had exactly the consequences that have brought globalization under attack.

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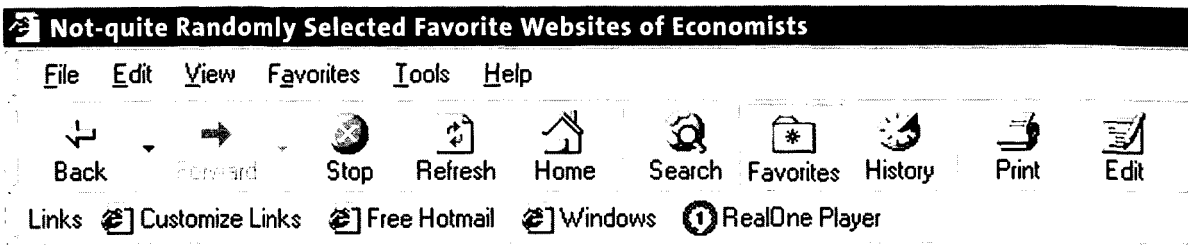

Six Degrees of Paul Krugman?

The Web now contains everything you always wanted to know about economics and much more. These sites, the personal products of distinguished economists, especially tickled my fancy. — P.P.

PAUL KRUGMAN
www.wws.princeton.edu/~pkrugman/
Unofficial site: www.pkarchive.org/

Everyone, it seems, either loves Paul Krugman, or loves to hate him. One reason is that he gets amazing exposure through his Op-Ed column in *The New York Times*. Another is that he writes better than any economist since Keynes. Yet a third is that he doesn't suffer fools (or knaves) easily – which often makes his opinion pieces a gas to read. His own Web site contains a sampling of his work, including some striking analytic pieces. But his unofficial site, run by Krugman groupies, is a whole lot more complete, and a whole lot more fun. It includes a lot of material about Krugman as well as stuff by him.

XAVIER SALA-I-MARTIN
www.columbia.edu/~xs23/home.html

Some economists are smart. A few are funny. A very few, including Columbia University's Xavier Sala-i-Martin are smart and funny. Who else, after all, would grace his home page with a picture of Miss Piggy in her pigs-in-space getup, and a pair of floating eyeballs that follow your cursor around the site? Check out the picture of his favorite supermodel. Or his link to a live webcam shot of downtown Barcelona (Sala-i-Martin is a Catalan). Then use the site to browse macroeconomist Sala-i-Martin's distinguished and extensive research.

ROBERT SHILLER
aida.econ.yale.edu/~shiller/

Robert Shiller of Yale University caught the zeitgeist with *Irrational Exuberance* (Princeton University Press), his book about the psychological underpinnings of the stock market. A sample chapter is on his Web site, along with chapters from his other books and pretty much everything technical he's written in the last decade. I like his statistics section, which provides a ton of data used in testing hypotheses about what drives the markets.

RICHARD FREEMAN
www.nber.org/~freeman/

I'll confess there is nothing special about Richard Freeman's Web site – it's just a well organized site containing a fine sampling of this Harvard University labor economist's research. But I was happy to have the excuse to advertise Freeman's work. He's an interesting scholar and an able defender of left-center views in a world that has drifted to the right.

RUDI DORNBUSCH
web.mit.edu/rudi/www/

Rudi Dornbusch has been teaching macroeconomics and international finance at MIT since Gerry Ford was in the White House. But his views on public policy are as fresh – and as edgy – as ever. Don't mistake his skepticism for conservatism just because he has a PhD from the University of Chicago; he really belongs to the take-no-prisoners school of economics. The site includes a lot of his more accessible opinion pieces, plus some excellent reading lists prepared for his graduate courses.

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NOURIEL ROUBINI
www.stern.nyu.edu/globalmacro/

Roubini, who teaches at New York University's Stern School of Business, may not qualify as a famous economist. But he certainly knows his way around policy circles, having spent time at the IMF, World Bank, U.S. Treasury and the White House. He maintains a wonderful Web site that serves as a clearinghouse for news, data and analysis of international financial issues. Indeed, it would make a nice home page/portal for those who work in international economics. The neatest part: an in-depth bibliography on the Asian financial crisis.

BERT ELY
www.ely-co.com/default.asp

Bert Ely runs his own private consulting firm specializing in financial policy and banking. Ely's a very public character, though, who's bursting with interesting ideas about everything from inflation to bank deposit insurance to mortgage credit risk. And just about everything he's ever written is available on his well-organized Web site.

RAY FAIR
fairmodel.econ.yale.edu/

Macroeconomic forecasting has long been out of fashion in academia. Most of the macro computer models used today are maintained by private forecasting businesses and government agencies. Ray Fair of Yale University is the exception – a rigorous academic who takes forecasting seriously. What's more, he's a natural born teacher, maintaining a unique Web site that allows visitors to plug their own assumptions into his sophisticated computer models of the U.S. economy and the global economy, and grind out do-it-yourself forecasts. The process takes some knowledge of economics and a bit of hard work to learn. But it's just a fab resource for those who want to understand what lies beneath the numbers.

BRAD DELONG
www.j-bradford-delong.net/

You may remember Brad DeLong as a former Deputy Assistant Secretary of the Treasury in the Clinton administration, or as Larry Summers's sometime alter ego. Since 1997, he has been on the faculty at the University of California (Berkeley), where he struts his stuff both as a first-rate scholar with eclectic interests and as an evangelist for post-liberal economic policy. His Web site is just chock-full of ideas, including most of his recent writing, sample chapters from his macroeconomics textbook, revealing graphs, weird links, and even semi-weekly musings in his personal journal.

JOEL SLEMROD
taxpolicyresearch.umich.edu/

Joel Slemrod, an expert's expert on the economics of taxation, directs the University of Michigan Business School's Office of Tax Policy Research. Strictly speaking, this Web site is the Office's, not Slemrod's. But this marvelous source of info on tax policy is obviously Slemrod's baby. Use it to keep up with current events in tax policy, or mine the ambitious World Tax Database that includes numbers on localities ranging from Alabama to Zimbabwe.

STEPHEN ROACH
www.morganstanley.com/about/gef/team.html#ssr

Wall Street economists don't get no respect. And understandably so: they are all too often shills for whatever lines their employers are peddling. But there are exceptions, and Stephen Roach, the chief economist at Morgan Stanley Dean Witter, is a big one. He heads a solid analytical team, which puts out a daily commentary on economic policy and events called the "Global Economic Forum." It's an excellent site for those interested in macroeconomics – one that bridges the gap between academic and business economists.

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Couldn't make it to the fifth annual Milken Institute Global Conference, held in Los Angeles in April? Here's a taste from the panel of Nobel Prize winners in economics. Note that the text has been edited for readability. — Peter Passell

A Nobel Round Table

MICHAEL MILKEN: Our four Nobel Prize-winning panelists have something in common – all were at the University of Chicago some time during the mid-1960s to early 1970s, a period in which Chicago may have had the strongest economic research group ever assembled.

Gary Becker, who won his Nobel Prize in 1992 for developing the concept of human capital, is today a professor of economics at the University of Chicago. **Robert Fogel** – to avoid confusion, we'll call him Bob – is also a professor of economics at Chicago, and the director of the Center for Population Economics at the Graduate School of Business. Bob won his prize for applying economic theory and quantitative methods to explain economic and institutional change. **Myron Scholes** is a professor of finance emeritus at Stanford University, but received his PhD from Chicago. Myron won his Nobel Prize in 1997, for coauthoring the Black-Scholes option pricing model.

Robert Mundell is a professor of economics at Columbia University, but taught at Chicago for many years. Both Bob and Robert were born in the Toronto area. Thank you, Canada. Robert won his Nobel in 1999 for work on optimal currency areas – a subject we are definitely going to address today in the context of Europe.

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Left to right: Myron Scholes, Bob Fogel, Michael Milken, Robert Mundell, Gary Becker.

COURTESY OF THE MILKEN INSTITUTE

Starting with you, Gary. Can you give me two examples of economic opportunities in the world today, as well as two challenges?

GARY BECKER: I'll begin with the challenges. One is that many countries are very rich and many others are very poor. Do we know enough to bring the poor countries' living standards closer to those of the rich?

The second challenge relates to low birth rates. If you count China (where birth control is not completely voluntary), something like 45 percent of the world's populations are reproducing below replacement levels. The world hasn't seen a situation like that for hundreds of years – maybe never.

The first opportunity is the other side of the challenge of raising the living standards of the poor nations. And I will just mention three factors that I think research has demonstrated are important – maybe even necessary.

One is free markets, in particular, having flexible pricing in labor, product and financial markets. Two is investment in people, in their education and training. Three is having an open economy.

The second opportunity – also a challenge – is the environment. How do we bring economic analysis to bear on environmental problems, allowing us protect the environment without doing a lot of foolish things?

Take the example of water resources. Most of the water in the world is not priced. Yet most of the water in the world is used not for drinking and cleaning, but for agricultural

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irrigation and manufacturing. So obviously, we are going to use water recklessly.

MILKEN: On Gary's first point, note that 15 percent of the world's population commands 85 percent of the world's economic resources. Turning to you Bob [Fogel], what do you see as the challenges and opportunities?

ROBERT FOGEL: The greatest opportunity of the 21st century is to add as many years to life expectancy as we did during the 20th. Life expectancy in the rich countries at the beginning of the 20th century was about 45 years. At the end of the century, it was maybe 77. By the end of the 21st century, it could be close to 100 years.

Good health matters as much as longevity. In 1910, 95 percent of all Americans who lived to 65 had severe chronic conditions – on average, six or seven chronic conditions. Today, less than half of all 65 year olds are chronically ill. We can not only live 30 years longer, but nearly all of it in good health.

The challenge is how to permit technological change to do its thing. The fundamental source of economic growth is technological change, but it is also a great disrupter. So our problem is how to have technological change without international and domestic conflict.

A second challenge is how to narrow the gap in longevity across countries. During the 20th century, China and India went from about 30 years life expectancy to 71 years and 60 years respectively. And they did that in about a third of the time it took Western Europe to make the transition. So I think we can make great progress throughout the third world in narrowing that gap.

Finally, I see a challenge in privatizing health care so that it is available without long delays. We have the resources to manage that – it is an issue of having the proper institutions to permit it to take place.

MILKEN: Another challenge is paying for retirement by raising the return on savings. Without higher returns, particularly for Europe, governments will fall trillions of dollars short of what's needed to deal with the long-term entitlements. Myron, what does the view from Stanford look like?

MYRON SCHOLES: I hope we are an integrated world, so that Chicago views and Stanford views are not that divergent. But thanks, Mike.

I see a future of more and more chaotic events. That demands flexibility and an ever-increasing need for investment in education.

Second, we have a demand for capital around the world, but we also have a supply imbalance. Marrying the demanders of capital and the suppliers of capital more efficiently to end these imbalances is a challenge that will enhance wealth and value for society. In particular, this means providing liquidity and a reduction of information asymmetries.

Another challenge in a free society is building trust in markets rather than government. We know that markets (and people) are imperfect. But we have to realize that the government is imperfect as well.

ROBERT MUNDELL: One major problem is that of global governance – how to work out a system that is both effective and compatible with power in the world economy.

We have the United Nations, of course, but it does not work very well. We have the big power arrangements – and unilateralism. Thank heavens the only superpower is the United States and not some other country. But unilateralism is not a viable system for the long run.

We need something like a Group of Seven – a constellation of countries that can address the major issues. And we need specialized systems to handle specific problems. For example, for most of history there has been an international monetary system based on one

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or more of the precious metals. But 30 years ago, that system broke down and we moved toward a non-system. We do not have an international monetary system. And for the first time in 2,500 years, we do not have a global unit of account in international money.

That reality is not obvious to Americans because the United States accounts for 25 percent of world output and has a single currency. It has got a perfect monetary system for all its internal trade. The dollar is used internationally, too, which certainly saves the world from a lot of problems. But it is still not an international monetary system, and we need to work toward that.

The lack of an international monetary system shows up in the extreme instability of exchange rates, which do not reflect differences in price levels or inflation rates. Just over the past three years you have seen the euro – it is a great thing for Europe. But it is about 25 percent below the exchange value at which it started.

If you look back over the past history of the Deutsche mark-dollar rate or the yen-dollar rate, we see doublings and triplings of the relative values of currencies. I attribute the Asian crisis to the sudden appreciation of the dollar against the yen: from April 1995 to June 1998 the dollar went from 78 yen to 148 yen. This not only dried up Japanese investment in Southeast Asia and shut off growth in those countries, but created devastating problems for the Asian exporters that had tied their own currencies to the dollar.

The costs of this to all the small countries is enormous. Europe has now solved this problem by merging 12 currencies into the euro. But other countries are out of luck and there is no leadership at the International Monetary Fund or the World Bank to help them. I think this accounts for the devastating problems that Bob and Gary talked about earlier – the great problems of poverty that, to a large extent have been driven by mismanagement of macroeconomic policies.

The lack of an international monetary system shows up in the extreme instability of exchange rates, which do not reflect differences in price levels or inflation rates.

Let me make one last point. After World War II, we had the Bretton Woods arrangement based on gold and the dollar. The countries recovering from World War II could latch onto a system, giving them a ready-made macroeconomic policy framework. And that worked very well for 20 or 30 years.

Now that has broken down and the international institutions have nothing equivalent to offer to the 35 transition economies born with the collapse of communism. Five years after the end of the cold war their output was about 40 percent below what it had been when they started getting advice from the IMF and the World Bank.

MILKEN: If we look, for example, at job creation in Europe versus the United States over the past 30 years, it has been very low. Gary, do you believe the switch to one currency is going to lead to job creation?

BECKER: I don't think so. One currency may be desirable, but I do not think multiple

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currencies explained the flatness in the European employment growth. That comes down to microeconomic policies. I think Bob has overemphasized the macro policies at the expense of the micro.

Very heavy taxation of labor in Europe means that the cost of using labor is much higher than the wage the employees receive. This gap discourages firms from hiring labor.

And because the workers are only getting a fraction of what they cost employers, they are discouraged from working – particularly since Western Europe has had a very generous policy of payments to the unemployed. I always distinguish Great Britain from the other parts of Western Europe.

MILKEN: Why don't we take a look at that. There has been a dramatic change in unemployment between the U.K. and France, Germany, Italy and Western Europe in the past decade.

BECKER: I am glad you have these facts, Mike, when they confirm what I say.

The U.K. has what is called, derisively by some Europeans, "Anglo-Saxon labor market policy" – namely, flexibility to hire and fire workers. In the French, German and Italian systems, it is very difficult to get rid of workers once you hire them. The latter systems are good for the people who have jobs, but very bad for those trying to get them.

These labor-market issues have very little to do with currencies. Well, maybe the commonality of the policies that you are trying to generate in Western Europe under the rubric of a common currency will push countries in the right direction. But the basic problem for the Frances, Germanys and Italys is threefold: high taxes on labor, great restrictions on the ability to hire and fire workers, and very generous payments to people who are not employed. These policies are sometimes used to encourage workers to retire early – the average retirement age in continental Europe is just 58.

MILKEN: Myron, advanced financial technology has allowed the United States to flourish compared to Western Europe. Isn't it ironic that much of this financial technology, such as the securitization of loans, is now owned by European financial institutions?

SCHOLES: Europe lacks a capital market as we know it in the United States. We are very much equity-based in the United States, while Europe is mainly bank-based.

European corporations are coddled by their banks – the relationships are very cozy. So there has never been the same market-driven discipline in Europe that has existed in the United States since the development of financial technologies in the 1970s.

Well-developed equity markets quickly punish failure and reward success, directing capital to the right investments. That is missing in Europe. It is one thing to own the financial institutions that own the sophisticated financial technology. It is quite another to be able to use the technology efficiently. Europe will need more developed equity markets before we see as great a use of this technology on the continent.

MILKEN: Essentially, we have moved to a market economy – rather than a bank- or a relationship-fueled economy – where assets are in the hands of tens of thousands of money managers. This democratization of financial assets has led to the democratization of industrial assets, which has led to the dem-

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ocratization of career opportunities.

Moving on: two countries are of particular interest to the United States – Russia and Mexico. Russia has nuclear weapons; Mexico has a huge population on our southern border.

Russia encompasses about 17 million square kilometers – more than eight times the size of Mexico. The population of Russia today is 145 million, about 50 percent bigger than Mexico's. And Russia consumes four times as much energy as Mexico. Yet Mexico's economy is more than twice the size of Russia's today, as measured in dollar terms.

BECKER: There is often an enormous overemphasis on the role of natural resources in economic progress. Russia has lots of oil plus a variety of other minerals. Nevertheless, not only Russia, but also a lot of other countries in the world with substantial natural resources, do not rank very high in per-capita income. Why? That is one of the challenging questions in understanding the difference in poverty and wealth across different nations.

Russia illustrates a number of principles. One, the economic system matters enormously in terms of how well you harness your human and your natural resources to produce real wealth. You can have enormous resources sitting there, but it does not amount to anything unless you have the right incentives.

Throughout the communist era, Russia had high levels of education, just as Cuba does now. But what the average educated person did with those skills – where they worked, how hard they worked, and so on – was badly distorted by the incentive structure.

And so the Soviet Union wasted a lot of its investment in human capital. Post-Soviet Russia is only slowly getting its act together.

The difference between Mexico and Russia, in a nutshell, I think, is that Mexico has made much better use of its human capital, through a better economic system and a wiser investment pattern.

MILKEN: Actually, Russia's top export is not oil, but human capital. A trillion dollars worth of human capital has left Russia for the rest of the world. Europe, the United States and Israel have benefited from that movement.

Another subject: Robert, you spoke about the weakness of the yen as causing problems as other countries peg their currencies to the dollar. What do you see as Japan's potential?

Here we have a country with enormous liquidity, that has very low yields on that liquidity, and an aging population. Could that capital be deployed in Asia for development? Could it be deployed within the country itself? What needs to happen to unlock assets measured in tens of trillions of dollars?

MUNDELL: Japan got into great difficulty managing its economy, in large part because of the mismanagement of exchange rates all the way back to the 1980s. Between 1955 and 1970 the Japanese economy grew at an average annual rate of 12 percent – the most rapid growth sustained for such a long time in history. And they did it with a very explicit policy – a fixed

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exchange rate of 360 yen to the dollar. That became their monetary policy. Money creation came solely as a result of purchases of foreign exchange.

Along with the rapid growth came rising tax revenues and a budget surplus, making tax cuts possible almost every year during the 1960s. So that there was a systematic process of tax cuts, combined with a fixed exchange rate and market-driven monetary policy.

It is no accident that, when I first was working out some of the propositions of supply-side economics, I looked at the Japanese economy. Japan was the perfect case in point.

MILKEN: In 1950, Japan made up 9 percent of the world's stock market capitalization. By 1988, Japan actually surpassed the United States and made up 40 percent of the world's stock market capitalization.

MUNDELL: That 1988 figure was a gross distortion. It was when people were saying that the value of the Imperial Gardens in Tokyo was equal to the value of all the land in Canada. What got Japan into its current problems was mismanagement of the exchange rate.

In the winter of 1985 and 1986 came this huge fall in oil prices. Oil prices went from $34 down to $10 or something like that. And this is what exploded the Japanese economy.

Along with the real estate boom came the appreciation of the yen. The yen tripled in value from the summer of 1985 to April of 1995. Any country that has its currency triple against the dollar, which was not in an inflationary mode, is asking for trouble.

The appreciation weakened the value of stocks of a wide range of Japanese companies. It ruined the balance sheets of a lot of those companies, which wrecked the Japanese banking system. Unfortunately, we are now past the point where the reversal of that overappreciation can solve the problem.

SCHOLES: There are other aspects of the Japanese situation that were unattended for a lot of years. A change in policy could have ended some of the difficulty much sooner.

Sweden had a real estate bust that caused its banks to fail. But instead of waiting 12 years to do something, Sweden decided to recapitalize the banks and go on with life.

The United States recently had a "bubble" as well. Greenspan quickly reduced interest rates, providing a lot of liquidity to the system that ended some of the difficulty. Japan waited around for four years before doing anything to revive liquidity.

In fact, in 1990 interest rates actually went up, which led to a lot of bankruptcies. And when you have bankruptcies it takes time to work things out.

MILKEN: The United States economy is quite different from those of Japan and Germany, in that we have more assets with money managers than we do with banks. Japan and Germany have relied on the banks to finance their economy.

In 1980, the largest bank in the world was the Bank of America. By the end of the 1980s, it had shrunk by half. But our economy did not need commercial bank lending to grow in tandem.

FOGEL: We should not lose sight of the real side of the economy. The financial side can either support or interfere with the real side. But economic growth depends primarily on the real side of the economy.

Japan's period of very rapid growth was 1950 to 1970. Long before it got into financial difficulties, its growth rate was down by 50 percent. And the great period of growth for the Asian tigers – South Korea, Singapore, Hong Kong and Taiwan – was 1970 to 1990. In other words, growth slowed substantially long before the 1997 crisis.

Since 1990, the great growth has been in

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China. Although external finance has played what I would call a strategic role, most of the growth in China has been internally financed. External finance has been a way of bringing in technology, which was necessary for the kind of transformation that we have been seeing.

I think the great growth area for the next few decades is going to be China. I expect the economy to grow at 6 to 8 percent annually.

If China keeps growing in that neighborhood and sustains the current income elasticity of the demand for cars, it is going to be consuming 45 million cars a year by 2020 or 2030 – which is about the world's current production of cars. So poor countries like China are going to be a great source for stimulating the richer economies of the world.

MILKEN: If we went back to 1900, we would see there was only really one country on the planet – England – where more than 50 percent of the people lived in urban areas. It took almost 200 years for people in the United States to move from the farms to urban areas. As recently as 1800, 90 percent of Americans lived outside cities.

Gary, how is China going to maintain social stability with 300 million to 400 million people moving to cities in the next few decades?

BECKER: Well, let me go back a little. Urbanization has been a key part of economic development. Modern economies are based on specialization and technology. And cities are much better at producing new knowledge and encouraging the degree of specialization needed to make the products of modern economies. So it is no great surprise that we get this great urbanization along with economic development. As China continues to develop, we should see the same sort of movements in China as we have seen elsewhere.

China and Japan illustrate a couple of major points that bear on the views of my fellow Chicagoans. When an economy is behind the rest of the world (as Japan was in 1950 and as China was in 1978 when it began its agricultural reform), if it implements decent economic policies, it has a great opportunity

to catch up. All countries that have followed these rules have managed to catch up – not always fully, but they have experienced rapid rates of growth.

That is the good news: we know something about what determines economic growth. If you put in a decent system, if you invest in your people, if you have an open economy, you are going to grow.

Japan did that; China has started to do that. Presumably, if China does not mess things up, it can continue to do that.

Yes, Japan has gone through great difficulties. But it is still a very rich country. The 1990s were a period of stagnation in Japan, a disgraceful period for policymakers. But Japan has not had a major recession that has knocked income way down.

Some slowdown is inevitable once you become rich. You can no longer continue to grow at 6 or 7 percent a year. The question is, do you have in place good macro policies – which are surely important – and good micro policies – which are at least equally important – so that you can continue to grow at 2 to 3

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percent? That is the challenge facing Japan.

A lot of people believed in the 1970s that Japan was going to surpass the United States. That has not happened. Now I think we have grown too pessimistic.

I have the same caution about China. China is doing great, but has a lot of catching up to do. If it does not mess things up, it can certainly do better. Will it join the rich countries' club? I think we will have to wait before we can be sure about that.

MUNDELL: I want to say something about macro policies and micro policies because, as Gary says, they have to work together. If you have bad macroeconomic policies – for instance, if you have got hyperinflation, if you have got big budget deficits – that dominates the concern of policymakers and nothing gets done on the micro side.

I pushed very strongly for the euro, mainly because it would get Europe on the right track on macro policies so they could then turn to their micro policies. I have said over and over again that Europe needs a supply-side revolution.

Michael offered comparisions of job growth in Europe and the United States. Now, of course, the real reason for rapid job growth in the U.S. has been the rapid growth of the American population. The European population has been stagnant, and so employment cannot rise very much.

But there is a major problem of unemployment in Europe. In the 1950s and '60s the star economic performers were not just Japan, but all the European economies – the German miracle, the Austrian miracle, the Italian miracle and so on. Fixed exchange rate systems gave them their monetary policies. They had low inflation and low tax rates.

Today, Europe is in bad shape, Japan is in bad shape, and the U.S. is in great shape. What caused the reversal was the change in policies – Europe started to imitate American policies. Meanwhile, America had a supply-side revolution in the 1980s, when the highest tax rate at the federal level went from 70 percent to 28 percent. The corporate tax rate came down from 48 percent to 34 percent.

Europe was going in the other direction. In the 1950s and 1960s, government spending in Europe was 25 percent to 30 percent of GDP. Now it is something like 50 percent of GDP. And in the Scandinavian countries, it is around 60 percent of GDP, because the principal focus of government in Europe has been the redistribution of income rather than the delivery of services.

Europe has to have a supply-side revolution. Every country has a labor law that says for firms with more than a certain number of employees – 15 in Italy, for example – they cannot fire people unless they go through the courts. Labor becomes a fixed factor. And what that has done is move the European unemployment rate, which was 2 and 3 percent in the 1950s and '60s to something like 9 or 10 percent – and 14 percent in Spain.

In a way, I'm enjoying the result of the French elections [in which the far-right party of Le Pen polled second]. Not because I like Le Pen, but because it means that Chirac is going to be able kill the Franco-German plan for a socialist Europe. Because essentially, you are now getting right-of-center instead of left-of-center governments in Europe. You are going to have a real chance to have a major revolution that will turn Europe around.

I attribute this crisis in part to Europe's demographic problem. Thirty years ago, there were five or six or seven workers for every pensioner, and now it is getting down to be two or three. So their pension systems that start at the age of 55 are no longer viable.

MILKEN: Robert is going for his second Nobel

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Prize today. You moved Europe to one currency; now you're going to move it to supply-side economics.

With just a few minutes left, I want to raise two other issues. One, which was discussed last night by Hernando DeSoto, is the underground economy. How do we get wealth out of the underground and into an official economy? How do we free up the assets?

The other is health care costs. How do we provide adequate service to an aging population? In the United States, health care is at least 15 percent of GDP, with much of the cost induced by lifestyle.

BECKER: The problem of the underground economy is pretty straightforward. When you tax the above-ground economy heavily, when you have very substantial regulatory obstacles for starting new businesses, when you heavily regulate the use of labor, there is a great incentive to avoid government. So people set up firms or they work, and they don't report the activity.

Somebody will ask, what is the harm? It is, indeed, better than the alternative of not having the economic activity at all. But there is a downside: Among other problems, it is very hard to become big. So you get a lot of smaller companies, often at less-than-efficient levels of operation.

On medical care: we've had significant growth in consumption, and a lot of that, I think, is highly desirable. People are willing to spend on improving both the quality and the quantity of their lives.

There are really two problems here, though. One, we underinvest in basic medical research. The federal government puts about $35 billion a year into medical research, and I think that figure should be higher.

On the other hand, a lot of important and significant powerful interest groups – the elderly and others – have the political clout to demand excessive expenditures on medical care for themselves.

So while I think it is good to have a high expenditure on medical care, there are a number of misallocations we have to address. One is the basic research; another is the distribution of benefits among groups.

Some slowdown is inevitable once you become rich. The question is, do you have the policies to continue to grow at 2 to 3 percent?

FOGEL: Let me return to a point that Mike mentioned earlier. England was the first country that was more than 50 percent urbanized. Why? Because English agriculture was incredibly productive. And so it took fewer and fewer people to produce the food.

In the United States in 1800, it took five people working on the farm to support one person working off the farm. Today, 2 percent of the labor force not only feeds – and overfeeds – the United States, but another 300 million people around the world as well.

So the key to being able to do everything else is to have very productive agriculture. And labor productivity in U.S. agriculture continues to grow in the neighborhood of 3 to 4 percent a year.

That sort of transformation is going to solve our health care problem. We can afford to spend not only the current 14 percent of

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GDP on health care, but considerably more: I forecast the figure will rise to 21 percent. That's because the production of food, clothing, shelter and consumer durables is becoming so incredibly cheap.

Let me conclude with one point. The share of the labor force in manufacturing today in the United States is lower than it was at the time of the Civil War – again, because productivity in that area has just leaped along.

SCHOLES: I think that I will talk a little bit about real estate. The U.S. economy is now pretty competitive and deregulated, and we have a pretty healthy financial system. The information and communication revolutions over the last number of years have helped in that regard, and we have higher productivity growth now.

We also have lower inflation and less government interference, some budget discipline, and a pretty decisive Federal Reserve. With our diversified economy, that tends to reduce risk premiums on investment; it tends to reduce the volatility we might otherwise see and insulates us better from shocks.

Much of this is missing in less-developed countries. As a result, it is much harder to think about borrowing very much against assets – in particular, housing.

One thing I worry about in the U.S. is that if we have this continual refinancing of mortgages, which allows for individuals to consume and to redeploy their assets elsewhere, we could end up with a situation like some U.S. corporations – one where senior executives borrow a tremendous amount against their stock, thinking it can only go up.

If we do end up with a market shock, the value of housing and real estate could fall quite dramatically, as people have to abandon or pay off their accumulated debts.

MUNDELL: I have focused on the reform of the international monetary system (which people aren't champing at the bit to do quickly). My own plan would be to take the basket of the dollar, euro and yen, and build an international currency out of that. And I think, in the next 10 years, that would be feasible.

It is not just an academic idea. People like Paul Volcker have argued that a global economy needs a global currency. Not a single currency, but a parallel international currency that can be used by everybody.

On the U.S. economy: it has been doing well. However, if the recovery sputters, two nagging problems are going to catch up to it. One is the current account deficit, which was 4 percent of GDP last year. That amount is being added every year to the net debtor position of the United States.

The United States also had big deficits in the 1980s. But back then, the U.S. was a creditor country. Now the United States is the biggest debtor country in the world, with something like 25 percent of GDP in debt and growing at the rate of 4 and 5 percentage points every year.

That is not an immediate problem, but it is going to become a problem at some point. And it is going to lead to substantial depreciation of the dollar. There is going to be a big shift of the dollars into euros, and that is going to create a big adjustment problem. That is why it is a good time now for the United States to talk its partners in Europe and Japan into doing something about the instability of exchange rates.

MILKEN: That sets the stage for a debate that we should have next year on whether the current account deficit is a significant problem. Of course, if we invited five million people to come to the United States, the value of their human capital would exceed all of the U.S. foreign debt. Let me thank you very much for participating.

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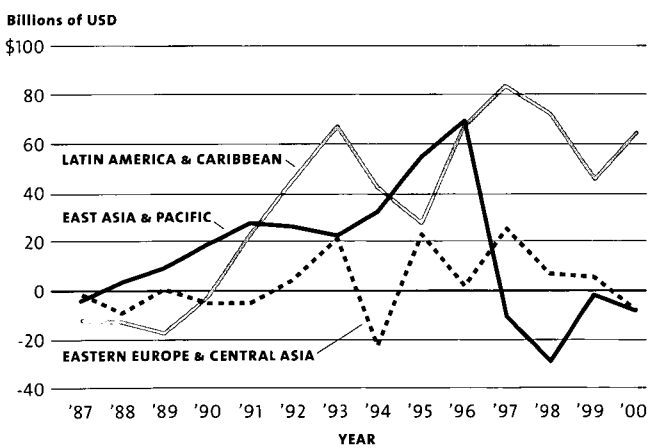
BY JAMES BARTH, DON MCCARTHY,
TRIPHON PHUMIWASANA, SUSANNE TRIMBATH AND GLENN YAGO

Many of the world's economies are still grappling with repercussions from the widespread currency crises of 1997-1998. In emerging markets in particular, capital flows remain sporadic and have yet to return to pre-1997 levels.

This situation persists because there is still inadequate popular support in emerging market countries (EMCs) for much needed changes in economic policy and corporate governance. Such support will only be garnered if most citizens are convinced that they will benefit from market-oriented reforms.

In practice, that means that they will have to have greater access to capital both for small businesses and home ownership. The payoff could be enormous, greatly improving the prospects for political and social stability worldwide. Fortunately, most emerging market economies – if not their citizens – seem ready for the transition. Some 50 countries with a combined population of 1.5 billion have already achieved gross domestic products per person comparable to those at which the United States and other countries first adopted middle-class oriented policies. The main barriers to achieving these goals are the lack of stable currencies, credible central banks, adequately capitalized regional and international financial institutions, and liquid, well-regulated capital markets.

NET CAPITAL INFLOW TO EMCs



SOURCE: International Financial Statistics

CAPITAL FLOWS

The currency crises since 1997, combined with Japan's financial and economic setbacks,

GLENN YAGO is director of the Capital Studies Group, JAMES BARTH is a senior fellow, SUSANNE TRIMBATH is a research economist, DON MCCARTHY and TRIPHON PHUMIWASANA are research analysts at the Milken Institute. An expanded version of this article, including the full rankings of the Capital Access Index, can be found on the Institute's Web site (www.milkeninstitute.org).

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2002 CAPITAL ACCESS INDEX: SELECTED COUNTRIES

2002 CAI RANK	COUNTRY	CAI 2002 SCORE	CAI 2001 SCORE	CHANGE IN SCORE
1	Hong Kong	5.65	5.58	0.07
2	United Kingdom	5.59	5.63	-0.04
3	United States	5.50	5.72	-0.22
4	Singapore	5.43	5.36	0.07
5	Switzerland	5.38	5.46	-0.08
6	Netherlands	5.35	5.49	-0.14
7	Canada	5.22	5.25	-0.03
8	New Zealand	5.16	5.14	0.02
10	Australia	5.00	5.08	-0.08
10	Finland	5.00	5.04	-0.04
10	Taiwan	5.00	5.00	0.00
14	Germany	4.96	5.09	-0.13
16	Japan	4.88	4.85	0.03
18	South Korea	4.78	4.64	0.14
21	Israel	4.71	4.74	-0.03
24	France	4.66	4.81	-0.15
26	South Africa	4.62	4.47	0.15
28	Malaysia	4.56	4.63	-0.07
29	Chile	4.53	4.72	-0.19
30	Italy	4.45	4.54	-0.09
31	Thailand	4.37	4.56	-0.19
32	Jordan	4.24	4.04	0.20
33	Hungary	4.21	4.34	-0.13
34	Panama	4.19	N/A	N/A
35	China	4.18	4.17	0.01
38	Botswana	4.12	4.00	0.12
38	Poland	4.12	3.84	0.28
42	Czech Republic	4.06	4.27	-0.21
42	Egypt	4.06	4.34	-0.28
45	Argentina	4.02	4.31	-0.29
47	Philippines	3.96	4.04	-0.08
52	Nicaragua	3.88	4.18	-0.30
53	Slovak Republic	3.83	4.00	-0.17
59	Qatar	3.70	N/A	N/A
62	India	3.68	3.85	-0.17
64	Mexico	3.65	3.77	-0.12
69	Brazil	3.59	3.77	-0.18
70	Pakistan	3.56	3.70	-0.14
75	Indonesia	3.50	3.76	-0.26
77	Saudi Arabia	3.48	N/A	N/A
82	Costa Rica	3.39	3.46	-0.07
83	Ivory Coast	3.36	3.54	-0.18
84	Colombia	3.35	3.51	-0.16
85	Turkey	3.33	3.48	-0.15
87	Venezuela	3.17	3.33	-0.16
91	Zimbabwe	2.89	3.24	-0.35
92	Ukraine	2.83	2.61	0.22
93	Russia	2.74	2.85	-0.11
95	Iran	2.64	N/A	N/A

NOTE: The Milken Institute's ongoing Capital Access Index (CAI) ranks countries by entrepreneurs' ease of access to capital. The five components of the CAI are:
- General economic environment
- Efficiency and competitiveness of the banking system
- Equity and bond market development
- Access to international capital
- Sovereign credit ratings

dramatically curtailed worldwide appetites for investing in EMCs. Each of the three large regions of EMCs – Eastern Europe, East Asia and Latin America — have seen a collapse in capital flows since 1997, and both East Asia and Eastern Europe have actually suffered net capital outflows.

GLOBALIZATION AND GROWTH AT RISK: CAPITAL ACCESS POST-9/11

Against this backdrop, global capital access took another dramatic plunge after September 11. During the third quarter of 2001, the gross volume of capital raised by EMCs in the international capital markets fell by more than 50 percent. The immediate effect of Sept. 11 was a flight to quality in fixed income investments in the U.S. Investors, fearing a deep and lengthy recession, dumped high-yield debt for investment-grade bonds. When the market reopened after the attacks, the spread between the Merrill Lynch High Yield Master Index and the Merrill Lynch AAA-rated corporate index jumped from 7.5 percentage points to 9.2 percentage points. At the same time, the Fed's actions to increase liquidity steepened the yield curve, as short-term rates declined sharply but the long end remained unchanged.

Widening quality spreads and the steepening yield curve have brought the two-tiered capital market into sharp relief. Credit is cheap for investment-grade borrowers, but lower quality sovereign and corporate borrowers are out of luck. By no coincidence, integration of the world's economies appears to have stalled and, in some regions, is now reversing.

Net private flows to many emerging markets are likely to remain negative for some time. Should this trend continue through 2002, many emerging economies will have difficulty refinancing an estimated $160 bil-

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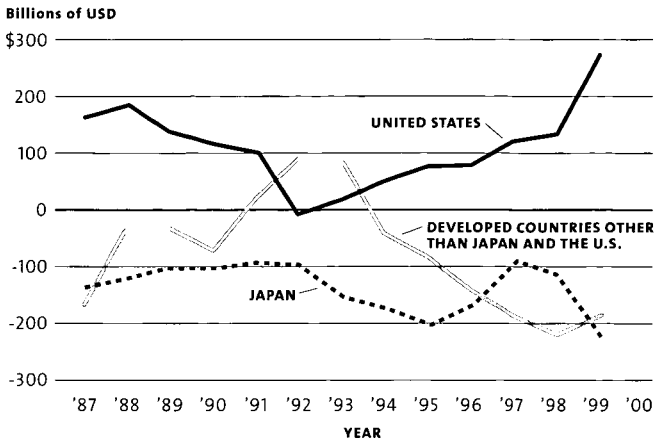
lion due in private debt. These problems will resonate throughout global financial markets and amplify systemic risk.

Falling portfolio flows and bank loans have been responsible for much of the decline. Note the changing pattern of capital flight for developing countries in the exhibit to the right. Capital from poorer regions has flowed into the developed countries – particularly the U.S., where it funds a widening trade deficit.

Meanwhile, foreign direct investment, typically a less volatile source of long-term funding, has changed little for EMCs in Europe, while inflows for EMCs in East Asia and the Pacific have declined only slightly. Latin America, on the other hand, has seen a greater inflow of FDI in recent years, although Argentina's default may dampen this trend.

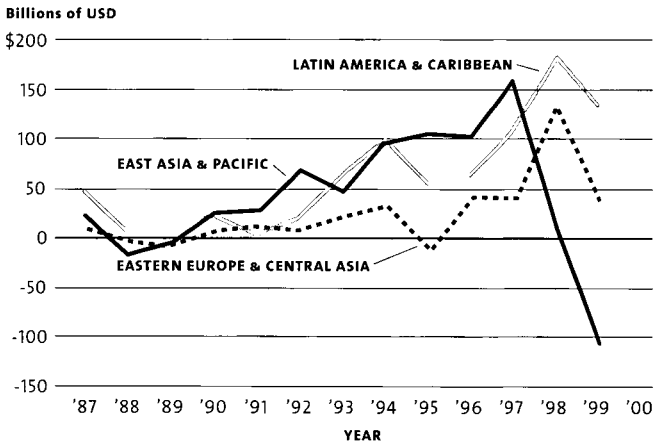
As private sources of capital for the EMCs have dwindled, multilateral lenders like the International Monetary Fund, whose resources have been diverted by more acute financial crises, have not covered the resulting shortfall. Indeed, growth in the resources of these institutions has failed to keep pace with the volume of international capital flows. In 1990, IMF resources were equal to 220 percent of private capital flows to emerging markets; by 1999 this figure had fallen to 96 percent.

NET RECEIPTS OF FLIGHT CAPITAL



SOURCE: World Development Indicators, World Bank

NET CAPITAL FLIGHT FROM EMCs



SOURCE: World Development Indicators, World Bank

GLOBAL TRADE

The threat to international financial integration posed by the decline in capital flows to EMCs is reflected in the stalling of global trade in 2001. Trade in merchandise, which grew an average of 6 percent annually between 1990 and 2000, rose by just 1 percent in the first half of 2001.

MISSING MARKETS

Growth in jobs, income and wealth are closely

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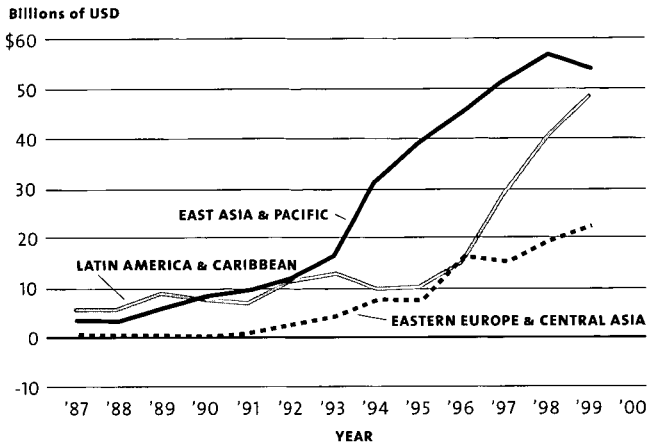
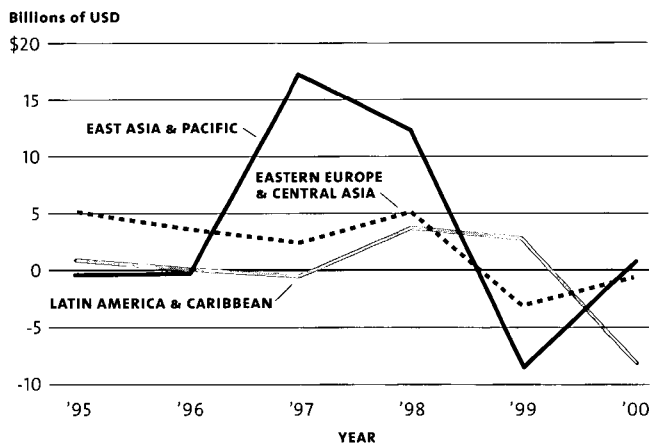
NET FOREIGN DIRECT INVESTMENT IN EMCs



SOURCE: World Development Incdicators, World Bank

NET IMF FINANCIAL FLOWS TO EMCs



SOURCE: World Development Indicators and International Financial Statistics

tied to the development of financial institutions and markets. Financial system development, as measured by the ratio of credit to gross domestic product, is, in turn, negatively correlated with economic volatility. Access to capital is the key for mobilizing savings, reducing risk over time and across industries, monitoring managerial behavior and achieving efficient asset pricing.

In addition to fostering economic stability, a deep and liquid financial system would engender social stability. It would nurture the development of a middle class, bridging existing income polarization. It would provide access to futures markets, which allow commodity producers to protect themselves against the idiosyncratic risks of farming. And it would even allow for more efficient conservation of fragile environmental assets by means of trading in emissions.

With a healthy bond market, an asset that would otherwise be classified as illiquid, such as property or a bank loan, could be securitized, allowing lenders to diversify their exposure to one borrower and thus extend more credit. Decades of dependence on banks as the main channel of capital allocation and sluggish development of equity, bond and venture capital markets have made such diversification impossible – and the recovery in the Asian economy, as a prime example, more difficult.

What is true of Asia also holds for most developing countries where financial systems development has been arrested by inactive – and thus illiquid – financial markets. Domestic financial intermediaries and markets in developing countries are often small and weak. Of EMCs, only China and Brazil have financial assets that amount to more than 1 percent of the world total. An inactive market is tantamount to no market at all. Small markets not only have higher operating costs, but

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also are riskier. Less liquidity leads to excessive volatility as prices fluctuate in the absence of market makers. Inefficient markets combined with insufficient and poor quality regulation, ineffective supervision and weak enforcement invite fraud and subsequent bank and market runs.

Dysfunctional banking systems tend to go hand in hand with dysfunctional stock and bond markets. Both occur in countries that poorly protect property rights, shareholder rights and creditors' rights.

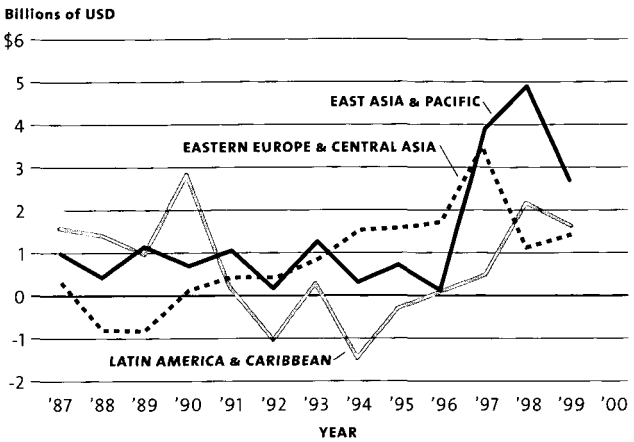
GLOBALIZATION'S BACKLASH: HISTORICAL PRECEDENTS

The current backlash against globalization is not unprecedented. At the beginning of the 20th century, many economies had highly developed stock markets. But, with the opposition to globalization that culminated in the unwinding of market integration and the retreat into autarky in the 1920s and 1930s, markets were downsized and their powers were limited through regulations supported by established economic interests. The effects of this retrenchment were not fully undone until the 1970s.

Not surprisingly, economic elites frequently lobby hard against globalization and capital flow liberalization. Open trade limits the ability of politicians to protect older firms. Capital access enables new entrepreneurs to attract foreign capital and local savers to invest in firms other than those controlled by existing elites. Today's anti-globalization forces focus on the same sore points as their 19th century counterparts – the costs of integration to established economic interests in both developing and developed countries, and the failure of globalization to provide a more equitable distribution of income.

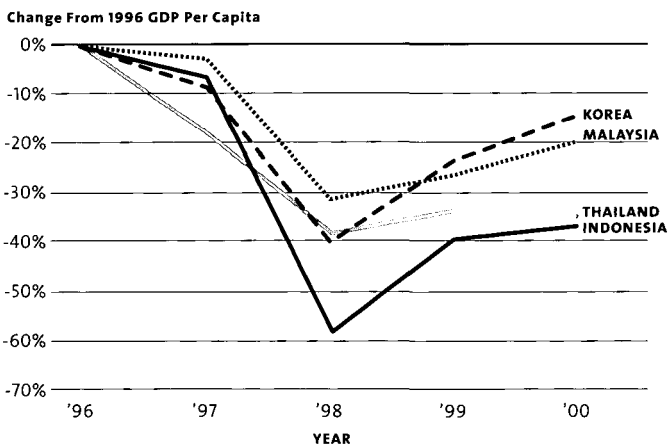
Globalization, which is guided by the same export-led growth policies that informed 19th century economic integration, also shares its principle flaw. Globalization has created a world economy, but has yet to produce a

NET WORLD BANK FINANCIAL FLOWS TO EMCs



SOURCE: World Development Indicators, World Bank

PER CAPITA GDP CHANGE IN THE ASIAN TIGERS



SOURCE: International Financial Statistics

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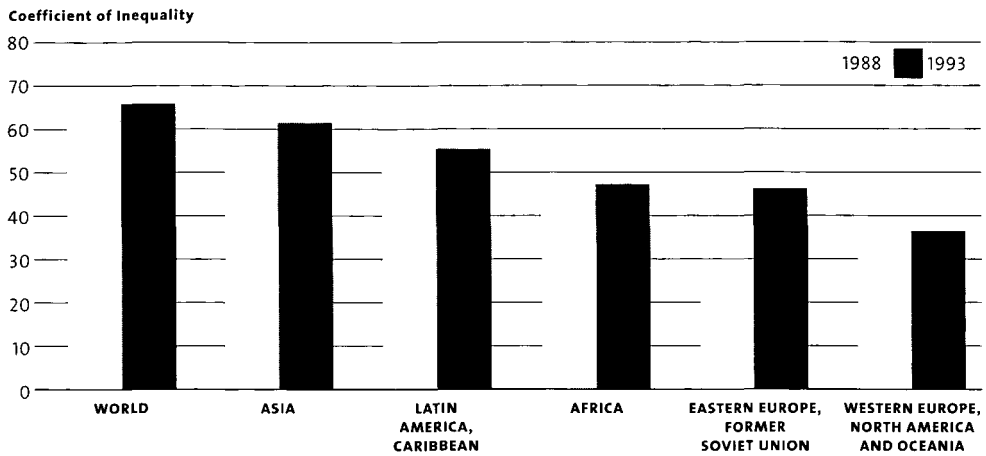
INEQUALITY IS HIGH AND INCREASING IN EMERGING MARKET COUNTRIES 1988-1993



SOURCE: UNDP, United Nations

world middle class. In fact there is evidence that inequality increased over the two great periods of globalization. But, the retreat into autarky failed to reverse the trend.

THE MISSING MIDDLE CLASS

The absence of efficient capital markets in many emerging economies, the diminishing ability to drive growth through exports, and the defensive efforts of long-standing economic interests have led to growing income polarization both within and between countries in recent decades. They have thus undermined the rise of a middle class that could be a source of growth-enhancing cultural values and sustainable demand-driven expansion.

A recent World Bank study assayed this striking level of income polarization. It assumed, somewhat arbitrarily, that the global middle class consisted of people with incomes, adjusted to represent purchasing power, between $3,470 and $8,000. The researchers estimated its size at 11 percent of the world's population. Some 78 percent of the world was described as poor, with incomes below the $3,470 threshold.

Unlike most OECD countries, which have a large and dominant middle class and smaller groups of poor and rich, the EMCs are characterized by two extremes. There are some rich individuals, a great many poor and a tiny number of people who might be deemed middle class. And inequality has risen even over the last few decades. Only the wealthy countries of Western Europe, North America, Oceania and the mostly middle-income countries of Latin America have seen modest decreases in inequality.

The richest 10 percent of the world's population accounts for 50 percent of income, while the bottom half accounts for a mere 9 percent of world income. Comparisons between regions yield similarly striking disparities. For example, an individual with the median income in Africa would have an income in the bottom 5 percent in Western Europe, North America or Australia. Conversely, a person with the median Western European, North American or Australian income would be in the 95th percentile of incomes in Africa.

This lack of a sizable world middle class is

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COMPARISON OF REGIONAL AVERAGE INCOME

	A median income in the regions listed across the columns...	AFRICA	ASIA	WESTERN EUROPE, NORTH AMERICA AND OCEANIA	LATIN AMERICA	EASTERN EUROPE AND THE FORMER SOVIET UNION
...would place an individual in the following income percentiles for the regions listed down the rows.	AFRICA	**50th**	49th	73rd	74th	95th
	ASIA	52nd	**50th**	74th	75th	94th
	EASTERN EUROPE AND THE FORMER SOVIET UNION	28th	27th	**50th**	52nd	86th
	LATIN AMERICA	26th	25th	48th	**50th**	83rd
	WESTERN EUROPE, NORTH AMERICA AND OCEANIA	5th	6th	14th	17th	**50th**

SOURCE: Branko Milanovic and Shlomo Yitzhaki (2001), *Decomposing the World Income Distribution: Does the World Have a Middle Class?* World Bank working paper. http://econ.worldbank.org/files/1423_wps2562.pdf

both an efficiency and an equity issue. Using data from the UNU/WIDER-UNDP World Income Inequality Database, we find that income inequality is statistically correlated with lower overall per capita income levels.

By the same token, inequality is significantly correlated with weak property rights. A high Gini is associated with a higher score on the 2002 Heritage Foundation Index of Economic Freedom. The Gini coefficient is used to measure the breadth of diversion between incomes in a society; the higher the coefficient, the wider the disparity. The Heritage Index is a ranking of world economies' conduciveness to free enterprise. Those most conducive receive the lowest scores.

Critics of globalization are right when they claim that the world has a hugely unequal distribution of wealth and that this inequality is important. However, they are wrong in asserting that a retreat from globalization is the remedy. While it is true that inequality decreased in the OECD countries during the post-World War I period of autarky, inequality between countries increased.

Adherence to development policies that do not enhance growth challenges globalization in this century, too. What is needed is neither export-led growth nor autarky (the Hobson's choice of the pro- and anti-globalization debate) but rather globalization based on the democratization of capital access.

POLICY IMPLICATIONS OF THE GLOBAL CAPITAL ACCESS INDEX

Financial integration and financial sector development do not have to be sacrificed to flatten the global distribution of income. Development of a middle-class and development of an efficient financial sector reinforce each other; policies that facilitate wider home and business ownership also stimulate and strengthen the financial system. The problem of restructuring developing countries' debt can also be addressed through the creation of deep and liquid capital markets.

Capital market depth, in turn, is supported by the securitization of home and small business loans, credit-enhanced corporate debt issuance and the expansion of lending and equity investment to small- and medium-sized businesses.

Just as inequality is negatively correlated with prosperity, inequality is negatively correlated with the ability of entrepreneurs to gain access to the capital they require to open businesses or expand existing ones. Countries with high levels of inequality tend to be characterized by substantial barriers to capital access and thus, other things being equal, they tend to underperform economically.

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CALIFORNIA DREAMIN'

California cities remain strong in the annual Forbes/Milken Institute study of the best places to do business and advance a career in America. The 2002 Best Places survey, published in the May 27 issue of *Forbes* magazine, ranks 10 California cities in the top 25 spots, with San Diego capturing the No. 1 slot (up from No. 8 in 2001). The next nine: Santa Rosa CA, Las Vegas NV, Ventura CA, McAllen TX, Boise ID, San Luis Obispo CA, Oakland CA, Brownsville TX, Orange County CA. (Albuquerque get the nod for most improved.)

This is the fourth year the Institute and *Forbes* have published the survey, which ranks some 300 U.S. metros according to wage and salary growth, job growth and high-tech output, among other criteria. For details and the complete rankings, visit the Web sites of the Institute (www.milkeninstitute.org) and *Forbes* (www.forbes.com/bestplaces).

THINKING ABOUT MICROSOFT

No antitrust case in recent history has attracted as much public attention as *U.S. v. Microsoft Corp.* Nor has any antitrust case in memory raised as many complex, substantive issues of law, economics and public policy.

To further the dialogue, the Milken Institute and Kluwer Academic Publishers have released a new book, *Microsoft, Antitrust and the New Economy: Selected Essays*, edited by David S. Evans, senior vice president at National Economic Research Associates. The book's essays, written by critics of the government's efforts to regulate Microsoft, examine not only the court case itself, but also the broader questions of government regulation in so-called "new economy" markets.

Another book in the series, entitled *Mergers and Efficiency: Changes Across Time*, will be published this summer. Susanne Trimbath, a research economist at the Milken Institute, takes a close look at the forces behind corporate takeovers, and the impact of consolidation on firm performance.

All the books in the Milken Institute Series on Financial Innovation and Economic Growth are available from Kluwer Academic Publishers. Go to: http://www.wkap.nl/prod/s/MILK for details.

2002 GLOBAL CONFERENCE: NETWORKING FOR FUN AND PROFIT

More than 1,400 people gathered in Los Angeles April 22-24 for the Milken Institute's 5th Annual Global Conference, which focused on the theme "Building Prosperity in an Interdependent World."

Some 150 speakers – corporate CEOs, analysts from leading financial firms, senior public policy officials, Nobel laureates, academic experts, scientists, journalists – offered insights on topics ranging from Russia's economic prospects to the quality of business reporting. Luminaries included Peruvian development economist Hernando de Soto, Pulitzer Prize-winning biologist Jared Diamond, former Education Secretary William Bennett and four Nobel Prize winners in economics.

Next year's Global Conference will take

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Pondering prosperity in an interdependent world.

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place in Los Angeles March 31-April 2. For a summary of this year's conference, including audio recordings, photographs and slide presentations, visit the Institute's Web site at www.milkeninstitute.org/gc2002.

AND THE ENVELOPE PLEASE...

Eight scholars from the United States and England have been named winners of the 2002 Milken Institute Award for Distinguished Economic Research:

Justin Wolfers, assistant professor of economics at Stanford University's Graduate School of Business, for his paper, "Are Voters Rational? Evidence from Gubernatorial Elections."

John Bound, professor in the Department of Economics, and graduate students **Jeffrey Groen** and **Gabor Kezdi**, all of the University of Michigan, and **Sarah E. Turner**, assistant professor of Education and Economics at the University of Virginia, for their study, "Trade in University Training: Cross-State Variation in the Production and Use of College-Educated Labor."

Jason Cummins of the Federal Reserve Board, Division of Research & Statistics, Washington, D.C., and **Giovanni L. Violante** of the University of London, Department of Economics, for their paper, "Investment-Specific Technical Change in the U.S. (1947-2000): Measurement & Macroeconomic Consequences."

Bill Megginson, professor and Rainbolt Chair in Finance at the University of Oklahoma's Michael F. Price College of Business, for "Towards a Global Market for Venture Capital."

The Milken Institute's award was created three years ago to honor the best research in economics. The winners were announced at the Global Conference. Each winning paper comes with a $2,000 prize. To view the winning papers, visit www.milkeninstitute.org.

STATE OF THE GOLDEN STATE

The Milken Institute's 5th annual California State of the State Conference, a day-long examination of the fifth-largest economy in the world, is scheduled for Sept. 26, 2002, at the Century Plaza Hotel in Los Angeles. Some of the state's leading authorities from business, finance, public policy and academia will speak on the major issues facing California today, from its future in technology to the impact of immigration.

For details, visit the Institute's Web site at www.milkeninstitute.org, or contact the Institute's Events Department by phone at 310-998-2605, or by e-mail at conferences@milkeninstitute.org.

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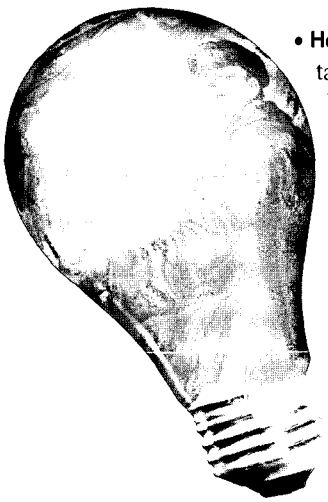
THE JOKE'S ON US



• **How many Marxists** does it take to screw in a light bulb?

None. The bulb contains within it the seeds of its own revolution.

– Thanks to Jon Titus, Editorial Director, *Test & Measurement World*

• **During a revolt** in a small country, rebels kidnapped an economist and an engineer. After several months, the rebels realized no one would ransom these people, so they decided to kill them. They went to the economist and told him they had to shoot him but would grant a final request. "Good," he said. "I have some of my papers with me and I'd like to give a final economic forecast for the next five years." Then the rebels went to the engineer and told him what was about to happen. "What is your final request?" they asked. "Shoot me first," replied the engineer.

– Thanks to Andy Obermueller, *Newark Star-Ledger*

• **Two guys go up** in a balloon. Eventually a strong wind comes along and brings a thick cloud cover. They steer and steer and finally find an opening in the clouds and come down through it. They see they are over a park, and yell down "Hey, can any of you people tell us where we are?" One guy comes running over to them yelling "I can, I can. You're up there in a balloon." One of the riders says to the other "that guy must be an economist." The other asks why. The first one says "Three reasons. He was sure he knew the answer. He was technically correct. And having heard his answer, we don't know anymore than we did to begin with." — Thanks to Bill Gale, Brookings Institution

THE HISTORY OF TEACHING MATH

• **Teaching Math in 1950:**
A logger sells a truckload of lumber for $100. His cost of production is 4/5 of the price. What is his profit?

• **Teaching Math in 1960:**
A logger sells a truckload of lumber for $100. His cost of production is 4/5 of the price, or $80. What is his profit?

• **Teaching Math in 1970:**
A logger exchanges a set "L" of lumber for a set "M" of money. The cardinality of set "M" is 100. Each element is worth one dollar. Make 100 dots representing the elements of the set "M." The set "C", the cost of production contains 20 fewer points than set "M." Represent the set "C" as a subset of set "M" and answer the following question: What is the cardinality of the set "P" of profits?

• **Teaching Math in 1980:**
A logger sells a truckload of lumber for $100. His cost of production is $80 and his profit is $20. Your assignment: Underline the number 20.

• **Teaching Math in 1990:**
By cutting down beautiful forest trees, the logger makes $20. What do you think of this way of making a living? Topic for class participation after answering the question: How did the forest birds and squirrels feel as the logger cut down the trees? There are no wrong answers.

• **Teaching Math in 2002:**
A logger sells a truckload of lumber for $100. His cost of production is $120. How does Arthur Andersen determine that his profit is $60?

How can you tell that macroeconomists have a sense of humor? They use decimal points.

Thanks to Avinash Dixit, Princeton University

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In this issue

BOB LITAN
On corporate disclosure after Enron.
If you can't lick the market, join it.

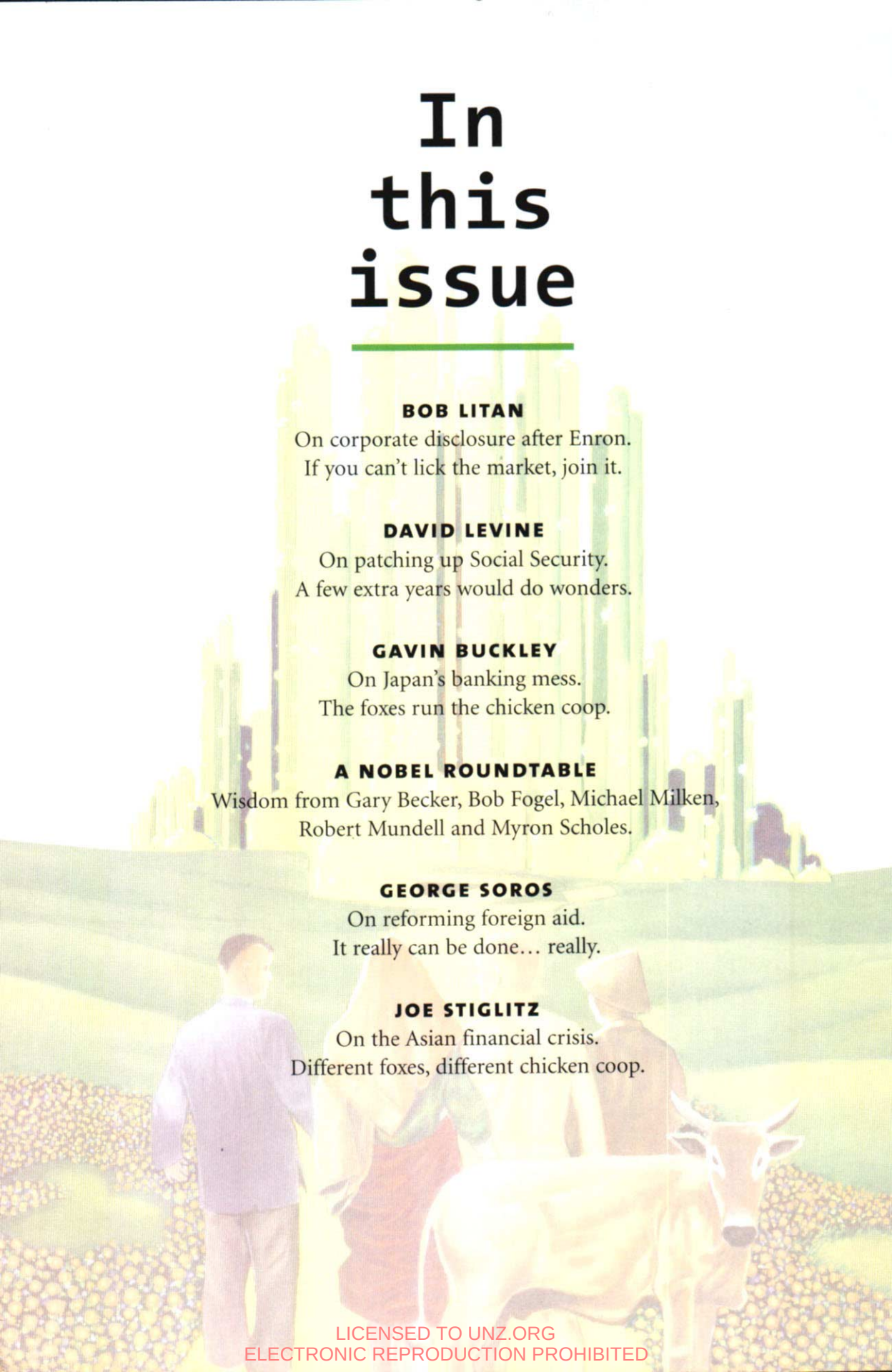
DAVID LEVINE
On patching up Social Security.
A few extra years would do wonders.

GAVIN BUCKLEY
On Japan's banking mess.
The foxes run the chicken coop.

A NOBEL ROUNDTABLE
Wisdom from Gary Becker, Bob Fogel, Michael Milken, Robert Mundell and Myron Scholes.

GEORGE SOROS
On reforming foreign aid.
It really can be done… really.

JOE STIGLITZ
On the Asian financial crisis.
Different foxes, different chicken coop.



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